TRANSITIONS FOR THE 90s

TWENTY-SEVENTH ANNUAL REVIEW

Economic Council of Canada

1990

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Foreword

Behind the blur of the extraordinary national and international events that have dominated the headlines in the past year, the Council has identified two fundamental transitions that will be crucial to the performance of the Canadian economy over the long term.

The first is the integration of various national and regional economic systems into a global economy. Canada has already made commitments to a free-trade agreement with the United States and to a reform of the federal sales tax, both of which are intended to provide a more favourable foundation for competition in global markets. But there is still much to be done to transform the array of goods and services that we produce – i.e., to shift from bulk materials to higher-value-added products – and to ensure that they embody both the high quality and the competitive price that will make Canadians successful competitors in world markets.

The Review shows that the changing pattern of exports and imports is having a profound impact on the composition of employment in Canada, making jobs disappear in the primary and manufacturing sectors and creating jobs in services. The large majority of Canadians appear to be adapting well to this changing job structure, in the sense that they are not experiencing more unemployment now than in the late 1970s. But a number of workers are now experiencing much longer spells of unemployment. This is particularly true in western Canada. Our analysis shows that much of the gap in unemployment rates between Ontario and other provinces can be explained by the slow pace of adjustment to the new job structure. That phenomenon is caused, in part, by social ties, but it is reinforced by government policies that are intended to preserve a traditional way of life.

Thus we have been faced with the paradox of an economy charging ahead at full capacity while unemployment rates fluctuated in the 7-to-8-per-cent range. That level of unemployment, unacceptable though it may be, is the level at which the inflation rate begins to rise. As prices accelerated in 1989, the focus of Canadian policies shifted to the control of inflation through restrictive measures that led to higher interest rates and a stronger dollar. Such policies cannot avoid creating higher unemployment and a larger fiscal deficit in the short run. The purpose of this Review is to identify new policy options that will enable monetary and fiscal authorities to meet their longer-range objectives of price stability and fiscal balance at a lower cost in terms of lost output and employment. In the longer run, our objective is to improve the efficiency of markets so that unemployment rates can drop to a level much lower than 7 to 8 per cent before inflation pressures begin to emerge. This can only happen with a change in both the institutions and the attitudes of Canadians.

The second transition that is required, therefore, is to build new relationships or institutions that can foster joint problem-solving by federal and provincial governments and by the public and private sectors. Progress on this front is still quite tenuous. The Review has examined the experiences of some countries that have managed to control inflation and keep unemployment rates low through tripartite efforts of this kind. We did not discover a universal model that could be transplanted to the Canadian scene; but, having identified

the strengths and weaknesses of other models, we do put forward a number of ideas that could provide the foundation for the development of a stronger sense of partnership between the players that influence Canada's economic performance and potential.

Chapter 1 surveys some of the changes now taking place in the world economy – the new global realities of the 1990s – and some of the demands that they will place on Canadians and their institutions. In Chapter 2, we present the medium-term outlook. We take a hard look at the cost of controlling inflation and at the way this cost is influenced by the expectations of ordinary Canadians. In Chapter 3, we analyse first the economic structure of Canada's regions and the nature of the unemployment problem in this country, and then go on to discuss how other countries have reconciled the tensions that arise when attempting to achieve full employment and price stability simultaneously. Finally, in Chapter 4 we take a close look at Canadian policies and institutions, and set out a number of options that would enable Canada to make progress in reducing inflation and expanding employment while reducing the federal fiscal deficit.

During the final stages of the preparation of this Review, Iraq annexed Kuwait, creating considerable uncertainty about the future trend in oil prices and in military spending by the United States and other countries. The potential economic impact of these events has been assessed in an appendix to Chapter 2, but these impacts have not been integrated into the policy simulations.

This Review was prepared under the direction of Ross Preston with the assistance of Jean-Pierre Voyer and the members of the Performance and Outlook Group, with support from the Unemployment Issues Group, led by Surendra Gera. I would also like to acknowledge the contribution of three Council members – Diane Bellemare, Yves Guérard, and Norman Wale – who played an active role in shaping the Review before their terms expired in May and June 1990. While they have not had the opportunity to sign the final draft, I hope they can see some payoff from the work they put into the early drafts.

Judith Maxwell
Chairman

Summary of the Options

This 27th Review sets out a number of policy options that will help Canadians to lower the rate of unemployment while controlling inflation. To reduce unemployment, we must find ways to improve the capacity of Canadians to adapt to the dramatic changes taking place in the world economy. We must also find ways to control inflation that do not involve periodic bouts of policy restraint that cause setbacks on employment, investment, and export sales.

Four ingredients are necessary to improve the adjustment capacity of the economy:

1 *Active labour-market programs*. Government income support programs must be altered so that they help people to adapt to a changing job structure rather than pay them to wait passively for a new job to come along. Unemployment insurance, for example, should be transformed into an employment-insurance scheme that would offer training, counselling, placement, and even relocation services as soon as workers become unemployed. (Also, subsidies to business must be altered so that they foster adaptation rather than "preserve a way of life.")

2 A *change in mindset* on the part of workers, business, communities, and governments.

- Workers must replace dependency on government transfers with self-reliance by investing in higher skills, using the new technologies, and exploring the scope for starting up their own businesses. They must also be prepared to experiment with new ways of organizing work and new forms of compensation.

- Businesses must invest in best-practice technologies, in the training of their employees, and in the development of new management practices and compensation systems.

- Individual communities must also take up the challenge of self-development by identifying market opportunities and mobilizing local resources to launch new businesses, whether owned privately or by community organizations.

- Provinces can do much to foster self-reliance and diversification by investing in training and technology and by removing obstacles to entrepreneurship.

3 A *partnership among the socio-economic players* that delegates the responsibility for labour-market programs to labour, business, and other economic agents. Direct participation in training and adjustment decisions should help to establish better working relationships between the social partners and produce programs that are focused on active support for workers.

4 A set of *monetary and fiscal policies* that work together to create a healthier economic environment. If these broad economic levers avoid extremes, the climate for job creation and adjustment will be improved.

Our second priority is to expand the arsenal of weapons for fighting inflation. New institutional arrangements will be essential during the period when the main focus of the federal government's fiscal policy will be deficit reduction. In the longer term, these ideas may well provide the foundation for a new approach to the formulation of economic policy in Canada. The key elements of these new arrangements are:

1 A *credible inflation target*. The Bank of Canada's objectives should be both clearly defined and stated in terms that are easy for the public to understand.

2 A *coordinated inflation target*. All levels of government and all public-sector agencies must assume more responsibility in the fight against inflation. Federal and provincial ministers should jointly establish guidelines with respect to decisions on government charges and on regulatory matters. These guidelines can only be truly credible if they are compatible with the target spelled out by the Bank of Canada. The guidelines should be voluntary, but performance should be monitored by legislative committees and through regular measurement of the contribution of government activities to the rate of inflation.

3 *Coordinated fiscal policy*. Federal and provincial governments should coordinate their fiscal policies to make them more attuned to both national objectives and regional differences. More coordination is also required between the federal government's fiscal and monetary policies.

4 *More flexible wages*. Reforms in the collective-bargaining system and the use of profit-sharing schemes should be given careful consideration, so that wage settlements become more sensitive to changing economic conditions. The objective is to ensure that the total wage bill will remain unchanged over time and, at the same time, to allow for greater stability in employment.

5 A *framework for social partnership*. Bolder initiatives (such as the implementation of voluntary incomes policies) based on a mature social-partnership framework could be envisaged as an option for a much longer-term horizon.

Transitions for the 90s

READER'S NOTE

The reader should note that various conventional symbols similar to those used by Statistics Canada have been used in the tables:

. .	figures not available
. . .	figures not appropriate or not applicable
– –	amount too small to be expressed
–	nil or zero

Details may not add up to totals because of rounding.

1 Global Change

There will be a strong temptation for Canadians to turn inward over the next few years, to focus their energies on a complex agenda of domestic issues. The country is entering a period of constitutional debate, at a time when there are renewed frictions between regions and intense pressures from the aboriginal peoples of Canada; the manufacturing sector is in a serious slump that could spread to the rest of the economy; and federal fiscal policy is handicapped by the government's huge debt and by strong resistance to higher taxes, leaving monetary policy to grapple single-handedly with cost and price pressures.

These issues are undoubtedly of great importance for the well-being of Canadians, but it would be a costly error to ignore global realities at this stage of the evolution of the world economy. We cannot allow gripping domestic issues to blind us to the dramatic changes that will be taking place in overseas markets in the 1990s. We must, in effect, manage two complex transitions at the same time. Internally, we must rethink our economic priorities and our institutions; externally, we must continue to adapt to the new global realities. World trading patterns will be altered by technological change, the reforms currently under way in the Soviet Union and Eastern Europe, the further integration of the European Community, the extraordinary expansion of the Asian economies, and the implementation of freer trade in North America. In addition, there is hope that the Uruguay Round of trade negotiations will strengthen the rules governing international trade.

These shifts in the world trade scene represent a new set of economic realities that will inevitably expose both the strengths and the weaknesses of Canada's industry and of its policy and institutional framework. They will also affect the nature of the jobs available to Canadians and influence the level of the interest rates that they pay.

New Realities

The postwar era is over; the post–Cold-War era has begun. In the 1940s, the transition from war to peace was dominated by the United States and its allies. The focus of their efforts was the creation of a global trading and payments system that would act as the foundation for sustained economic growth. This concept differed from the traditional European view. The history of Europe had been one of overseas empires that guaranteed access to raw materials and to markets for manufactured goods. In the late 1940s, the vision of U.S. and other strategists was to build a set of institutions that would create financial and political order.

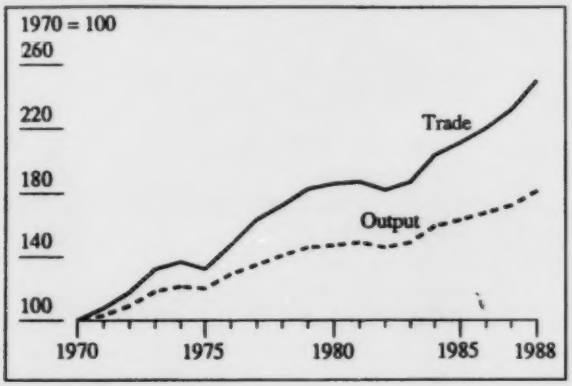
Thus were born the Bretton Woods Agreement, signed in 1944 and aimed at establishing a world exchange-rate and payments system – to be administered by the International Monetary Fund (IMF) – and at creating the International Bank for Reconstruction and Development (IBRD, or World Bank), an agency designed to promote international investment and development in the poorer countries; the United Nations, created in 1945 to manage the political dialogue among the countries of the world; the General Agreement on Tariffs and Trade (GATT), signed in 1947 and designed to provide trade rules and dispute-settlement mechanisms; the Organisation for European Economic Co-operation, created in 1948 as part of the Marshall Plan and transformed in 1961 into the Organisation for Economic Co-operation and Development (OECD) to promote policies that would foster economic growth in member countries. Institution after institution sprang up to ensure that the proper conduit would exist to defuse political and economic tensions. Over the past four decades, this process has produced extraordinary gains in living standards in many western countries. Trade has expanded tenfold since the late 1940s, rising by 6 per cent a year since 1983 (Chart 1-1). However, some regions, especially Africa and parts of Latin America, did not participate in these gains, and some of the institutions designed to help the poor countries, such as the U.N. Commission for Trade and Development (UNCTAD), have had very limited success.

The End of the Cold War

Not surprisingly, the relative economic strength of the major powers has changed over the four decades. Europe and Japan have rebuilt their war-shattered economies and now wield considerable economic might. Indeed, they have become partners of the United States in dealing with a number of international economic issues. And in certain areas, the United States itself faces a need for economic renewal.

Chart 1-1

Volume of World Merchandise Trade and Output, 1970-88



SOURCE Data from the GATT.

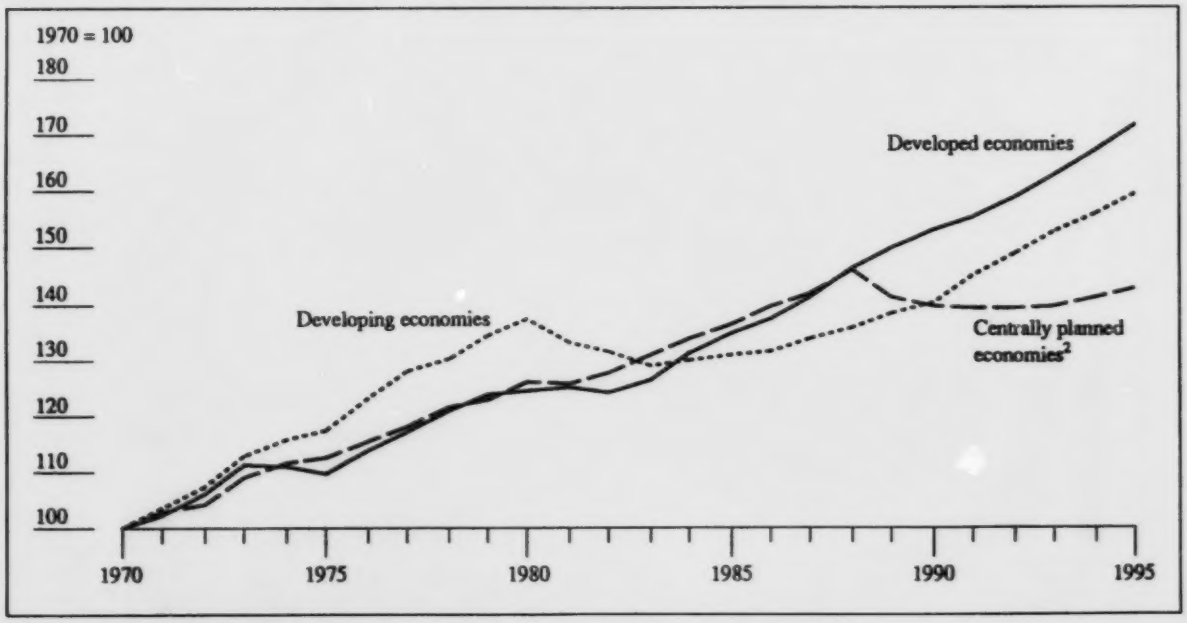
By the late 1980s, the need for reform was also sweeping the Soviet Union and Eastern Europe. The collapse of the Berlin Wall in late 1989 symbolized the release of important new forces that will influence the evolution of the world economic system. Thus the time has come to redefine political and military institutions such as the North Atlantic Treaty Organization (NATO) and the Warsaw Pact. But even more important in the long run, the time has come to reshape the major economic institutions with a view to incorporating the Soviet Union and Eastern Europe into the world trading system.

After the Second World War, the Soviet Union opted for a variant of the old European model, carving up Eastern Europe and parts of Asia into an empire that ensured both military security and access to raw materials and to markets for manufactured goods. The markets in this buffer zone were shielded from competition from the outside world not only by tariff barriers but also by political and, in some cases, physical barriers backed by military force. The Warsaw Pact and COMECON (the Council for Mutual Economic Assistance) were the institutions put into place to ensure that this model worked. Eventually, however, the costs of empire became too great.

Chart 1-2 compares the growth in output per capita in the centrally planned economies (including China) since 1970 with the patterns of growth in the developed market economies and the developing countries. Note that while output per capita in the centrally planned economies was

Chart 1-2

Real Gross Domestic Product per Capita, Selected Country Groupings, 1970-95[1]



1 The estimates for 1989-95 are projections.
2 Including the People's Republic of China.
SOURCE Data from the Wharton World Model.

much lower than in the West, these countries were at least able to match the rate of growth of the industrialized countries until the late 1980s, when a sharp decline in living standards began. Current estimates suggest that production will continue to decline in the Soviet Union and Eastern Europe until the reforms undertaken in the last few years begin to have an impact on production. That may take several years.

The slowdown in the growth of output per capita in the developing countries during the early 1980s shows the impact of weak commodity prices on resource producers and of the debt crisis in Latin America; the subsequent speed-up in the late 1980s reflects not only the appreciation of the U.S. dollar but also the remarkable transformation of a number of countries in the Asia-Pacific region into "newly industrialized economies." Their success has been closely tied to that of Japan, leading to the emergence of a third trading region, along with Europe, where growth is now stimulated by the effort to complete the integration of the internal market by the end of 1992, and North America.

These are the new realities that will create new competitors and new trading opportunities for Canadians. Whether they like it or not, these events far beyond their borders will reshape Canada's industry, its policies, and its employment structure. Thus it is important to review the most important long-term trends in the world economy and their implications for this country.

Renewal in the East

> You can help us most of all if you help the Soviet Union on its irreversible but immensely complicated road to democracy.
>
> *Vaclav Havel, President of Czechoslovakia, in a speech to the U.S. Congress*

The rapid developments that have taken place in Eastern Europe and the Soviet Union in the past year have caught the imagination of the world. Poland, Hungary, East Germany, and Czechoslovakia with decisiveness, Bulgaria and Romania with somewhat less finality, have rejected or reduced Communist Party rule and have begun to put into place a new set of political institutions and a market system for organizing production and setting prices. The Soviet Union has also made significant political reforms and, during the summer of 1990, was considering major changes to its economy as well.

These dramatic changes are likely to set off new shock waves in the world economy that will preoccupy policy-makers during much of the 1990s. As the economies of the Soviet Union and Eastern Europe begin to integrate into the world trading system, for example, their old trade patterns will be altered significantly (Chart 1-3). The volume of trade will expand, as export and import barriers fall and as new opportunities for exports to and from the region occur. Eventually, new competitors and larger markets will emerge on the world scene. Major shifts in world capital movements are also likely to occur. The extraordinary demand for new technology and new management techniques (which are frequently transferred through direct investment) will create a new source of demand in world capital markets, putting pressure on the pool of world savings.

Finally, the shock waves from these reforms will force a rethinking of the policies and the membership of major international institutions such as the GATT, the IMF, and NATO. At best, the Soviet Union and some of the Eastern European countries have the potential to become an important force in the world economy in the next century. At a minimum, we can expect them to interact with the developed economies much more extensively than has been the case over the past 40 years.

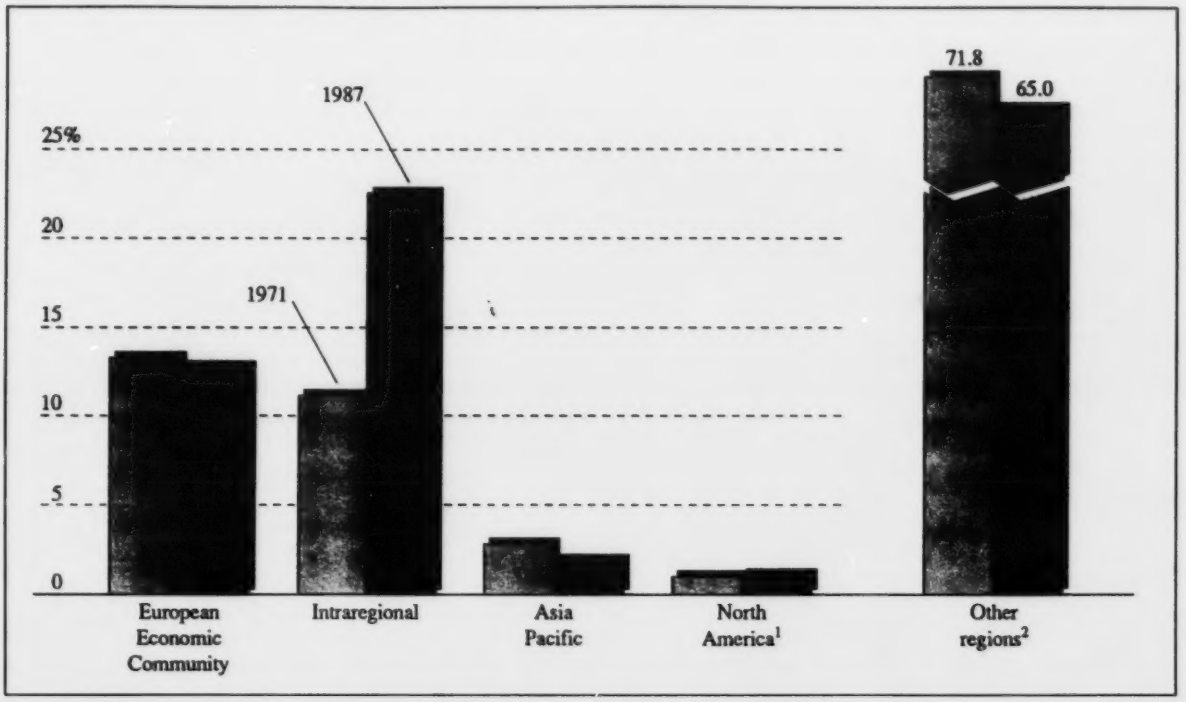
The linchpin that will determine both the speed of progress and the nature of the achievements of these countries will be the economic and political choices that are made in the Soviet Union over the next few years. For it is the Soviet economy which dominates the region that extends from East Germany to the Bering Sea: its 286 million people account for over two thirds of the population of the COMECON area; and, with its wealth of raw materials, it has long dominated the trade of the smaller countries of Central and Eastern Europe.

The road ahead will no doubt be a bumpy one. As Table 1-1 shows, living standards in the region are low – GDP per capita is roughly one third of the average for the OECD countries. Few people have cars; few homes have telephones; a very high proportion of the labour force works in the agriculture sector; the private sector is virtually nonexistent; and less than one third of the work force has a secondary-school or university diploma, compared with 61 per cent in the OECD region.

Although the Soviet Union and the Eastern European countries have maintained a very high level of investment in their economies – much higher than is typical of the industrialized countries – that investment (particularly in computerization) has not paid off in terms of efficiency or economic growth. Much of the economic might of the region has been focused on developing and maintaining military strength and heavy industry. Indeed, that is what has spurred on the architects of economic reform in the Soviet Union. The Deputy Premier has said, for example, that:

Chart 1-3

Destination of COMECON Exports, 1971 and 1987



1 Including Mexico.
2 The five major markets are Finland, Yugoslavia, India, Austria, and Sweden.
SOURCE Based on data from Statistics Canada's World Trade Database.

> Computers work only when the market is free, the flow of information is undisturbed and the people, as well as economic entities, whether they belong to the state, co-operatives, collective farms or private entrepreneurs, are competing with each other to obtain the best results.[1]

Hence the need for fundamental reforms. For nearly 70 years, the economy of the Soviet Union has been guided by the Communist Party, the State Planning Commission (GOSPLAN), and the State Committee on Prices. These three institutions formulated goals, organized production, and set prices.

Now, the challenge is to withdraw the controlling hand of the state and to redefine its role in a way that will, at the same time, provide for some measure of regulation of the market and a safety net to protect citizens from the hardships that occur when markets do not perform well. Already, several Eastern European countries are experiencing a rapid rise in unemployment – a phenomenon that was practically nonexistent before.

Early and rapid institutional change will be fundamental to successful reform. Change to a market-oriented system will require new ownership rules and property rights that provide the motivation to make efficient economic decisions. New legislation regarding accounting conventions, bankruptcy, competition policy, and trade policy will be required. Also, financial markets must be developed; currencies must become convertible; and more rigorous systems of government budgeting and management of the money supply are essential.

The dimensions of this transition are enormous, as will be the impact on trade. The Soviet Union is composed of a mixture of republics, autonomous regions, and political districts. Commerce was managed at a centralized level. Individual enterprises and regions had little opportunity to trade with each other directly, let alone with western countries, because ideology and bureaucratic arrangements at the top determined the flow of goods. As decisions are now being decentralized, and as direct trading between republics, between enterprises, and with the West begins

Table 1-1

Economic and Social Indicators, OECD Area and Eastern European Countries, 1980s

	Soviet Union	Bulgaria	Czechoslovakia	German Democratic Republic	Hungary	Poland	Romania	OECD
General indicators								
				(Millions)				
Population (1988)	286.4	9.0	15.6	16.6	10.6	38.0	23.0	824.8
				(Billions of US dollars)				
GDP (1988)	1,590.0	50.7	118.6	155.4	68.8	207.2	94.7	12,073.0
				(US dollars)				
GDP per capita	5,552.0	5,633.0	7,603.0	9,361.0	6,491.0	5,453.0	4,117.0	14,637.0
				(Per 1,000 population)				
Living standards (1987)								
Cars	50.0	127.0	182.0	206.0	153.0	74.0	11.0	385.0
Telephones	124.0	248.0	246.0	233.0	152.0	122.0	111.0	542.0
				(Per cent)				
Structural indicators								
Share of labour force in agriculture	21.7	19.5	12.1	10.2	18.4	28.2	28.5	8.0
Gross domestic investment/GDP	33.2	32.7	24.7	29.2	28.5	36.5	37.1	20.6
Share of private enterprise in NMP/GDP	2.5	8.9	3.1	3.5	14.6	14.7	2.5	70-80
				(OECD = 1)				
Relative energy intensity	2.6	2.2	1.9	1.6	1.5	1.9	2.7	1.0
				(Per cent)				
Proportion of workforce with secondary or higher education	27.3	..	29.4	..	33.8	28.9	..	61.0
Trade indicators								
Total exports of goods as a proportion of GDP (1988)	6.8	23.0	19.7	13.7	14.7	6.4	11.2	14.4
Change of share of OECD markets								
1979-89	-26.7	-18.5	-44.0	-25.2	-7.8	-32.3	-46.3	-
1986-89	-13.0	-19.9	0.9	-9.1	1.5	-23.5	-27.8	-

SOURCE Organisation for Economic Co-operation and Development, *OECD Economic Outlook* (Paris, June 1990).

to replace state trading, internal and external trade can be expected to explode.

The industrialized countries have already begun to respond to the opportunities for trade and the needs of the countries in transition. Figure 1-1 provides a summary of the institutional changes that have taken place, only one year after the beginning of the political changes that are transforming the Soviet Union and the Eastern European countries.[2] It illustrates the progress that these countries have made in moving towards membership in the GATT, the IMF, and the World Bank. Many of them have now signed bilateral agreements with the European Community; many are engaged in direct negotiations for debt relief or rescheduling; and many have received financial aid from their prospective trading partners. At the same time, the industrialized countries have been removing import restrictions against goods exported by Eastern Europe and the Soviet Union, and they are also reducing controls on exports of high-tech goods from the West.

The speed of these changes is determined to a large extent by the pace with which governments in the region are making the commitment to democracy and to the discipline of the market. But this is only the first stage in a process of gradual integration of these countries into the world economy. Over the next several years, the major priorities will be focused on access to business services, especially management training and technology transfer. Eventually, once private ownership and related institutions are in place, we should see a significant increase from the current trickle of direct investment, as corporations in the industrial world begin to develop more direct production and distribution links with these new market economies.

The Canadian government and some businesses are showing a direct interest in participating in these new markets, although Canada is well behind the European countries in establishing new trade and investment linkages. Canada has made a $30-million-a-year commitment for five years to a new European Bank for Reconstruction and Development (EBRD), which will help to finance both private-sector and infrastructure projects in the region. Canada has also offered financial assistance to Poland and is providing management training and business consulting services to Poland and Hungary; similar services may be offered to other East European countries in the future.

Given the regional tensions that are currently rending the Soviet Union and given the avowed intention of the central government to allow individual constituent republics to seek greater autonomy, the future political shape of the Soviet Union is likely to be some sort of loose federation or commonwealth of a large number of quite disparate republics. If the process of decentralization can be managed in such a way that the Soviet people are able to concentrate on rebuilding the economy rather than on ethnic and other social tensions, the process of integration into the world economy will bring with it a steady rise in living standards.

But there is the risk that the Soviet Union will be unable to complete its metamorphosis. If political and ethnic tensions begin to overwhelm the economic reforms, it will be very difficult for the Soviet government to achieve a recovery in agriculture and a restructuring of the manufacturing and service sectors. This more negative outcome, as implied by the remark of Vaclav Havel cited above, would have unfavourable consequences for the smaller East European economies. Some of these economies, such as Czechoslovakia's, are now so closely intertwined with that of the Soviet Union that it would be very difficult for these countries to achieve successful economic and political change if their major trading partner were not successful in its own reforms. The countries of Eastern Europe are also heavy consumers of energy, and thus they are especially vulnerable to a rise in world oil prices.

Even if the evolution in the Soviet Union is favourable, the progress of the smaller East European countries will depend very much on their capacity to maintain the political consensus needed to carry them through the hardships associated with the early years of change. No doubt, it will take some time before the peoples of the Soviet Union and Eastern Europe begin to realize the gains in living standards that now appear possible. The road ahead will not be an easy one for the governments or their people. Their progress, slow or fast, will have an important bearing on the evolution of the world trading system through the 1990s.

Stronger Trading Blocks

On average, world trade has grown nearly twice as fast as world output since the early 1970s. This is a sign that countries are becoming more specialized and that production systems are becoming more interdependent. In many respects, the interconnections within industries and within firms are now global, as component parts made in Asia are assembled in Europe or North America and sold in any country. The integration of production has led to the formation of global systems for marketing and distribution, and it is beginning to place immense pressure on governments to harmonize regulatory standards in order to facilitate the free movement of goods.

An analysis of export shares over the past 20 years also shows the gradual evolution of three distinct trading regions

Figure 1-1

Summary of Institutional Changes Integrating the Soviet Union and Eastern Europe into the World Economy, as of July 1990

	Soviet Union	Bulgaria	Czechoslovakia	German Democratic Republic	Hungary	Poland	Romania
Institutional ties							
GATT	Observer	Observer	Member	Via West Germany	Member	Member	Member
IMF	...	Applied	Applied	Via West Germany	Member	Member	Member
World Bank	...	Applied	Applied	Via West Germany	Member	Member	Member
Agreement with EC	Signed 1989	Negotiating	Signed 1988	Via West Germany	Signed 1988	Signed 1989	Postponed by EC
CSCE[1]	Member	Member	Member	Member	Member	Member	Member
Financial links							
Paris Club[2] debt relief	...	...	...	...	...	Signed 1990	...
Debt rescheduling	...	Negotiating	...	...	Tied to IMF austerity	In process	...
Direct financial aid	Minor amount	...	...	Via West Germany	Minor amount	Minor amount	...
Currency convertibility	Planned	Dual rates	Anticipated, presently dual rates	Via West Germany	Dual rates	As of January 1990	As of February 1990
Trade barriers							
Import restrictions by OECD countries	Conditional	...	Partly reduced	...	Partly reduced	Partly reduced	...
Export controls by COCOM countries[3]	Partly reduced	Reduction anticipated	Reduction anticipated	...	Reduction anticipated	Reduction anticipated	...
Business services							
Training	In process	...	...	...	In process	In process	...
Technology transfer	Joint ventures since 1987	Joint ventures since 1980	Joint ventures since 1986	Joint ventures since January 1990	Joint ventures mainly since 1986	Joint ventures since 1976	Joint ventures since 1972

1 Conference on Security and Cooperation in Europe.
2 Paris Club: Group comprised of official Western creditors (governments and agencies).
3 COCOM: Coordinating Committee on Export Control.

(Chart 1-4). Commerce within these regional groupings has been growing even faster than between them. More than 40 per cent of the exports of Canada, the United States, and Mexico are sold within North America; intraregional trade in Europe is in the same range, while the Asia-Pacific group of countries – a group that includes Japan, South Korea, Taiwan, Hong Kong, the Philippines, Malaysia, Singapore, Thailand, and Indonesia – conduct over 30 per cent of their trade among themselves. This trend towards intraregional trade will be reinforced in the 1990s by European integration, by the trade agreement between Canada and the United States, by Mexico's interest in a similar agreement with its northern neighbour – and, perhaps, with Canada as well – and by the integration of trade and production facilities in the Asia-Pacific region.

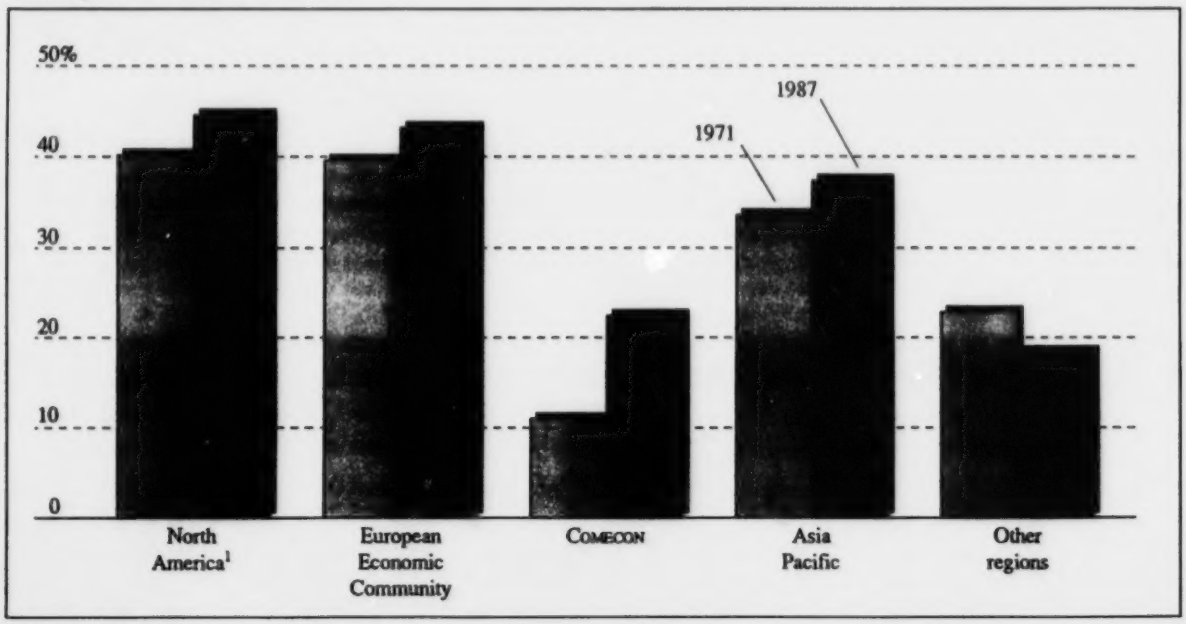
The growth of intraregional trade presents Canada with opportunities to expand trade through greater specialization and thus to increase income through the related gains in productivity. But a greater competitive challenge has also emerged: North America is no longer the locomotive of world economic growth. As Chart 1-5 shows, the shares of world exports originating in the United States and Canada fell between 1971 and 1987, reflecting the dramatic increase in the share originating in the Asia-Pacific region. Note that the share originating in Eastern Europe (COMECON) has been declining. COMECON was ahead of Japan and the Asia-Pacific region during the early 1970s. Two decades later, this has changed dramatically.

Western Europe's share remained unchanged during the period, but this region may turn out to be as dynamic in the 1990s as the Asia-Pacific region has been in the recent past. Membership in the European Community has grown to 12 countries, with a total population of 325 million. The Single European Act, adopted in 1987, has set in motion reforms (to be completed by the end of 1992) that include the removal of the remaining physical, technical, and fiscal barriers to trade, and the harmonization of standards in such areas as workplace health and safety, the environment, consumer safety, and tool specification. The prospect of such policy changes has created strong incentives for firms to plan production and distribution on a pan-European basis and thus give a major boost to trade within the region.

The motivation for economic integration is the increase in economic efficiency that occurs when firms specialize and produce for a larger-scale market. But restructuring production to bring about these efficiency gains requires substantial investment in plant and equipment. This, in turn,

Chart 1-4

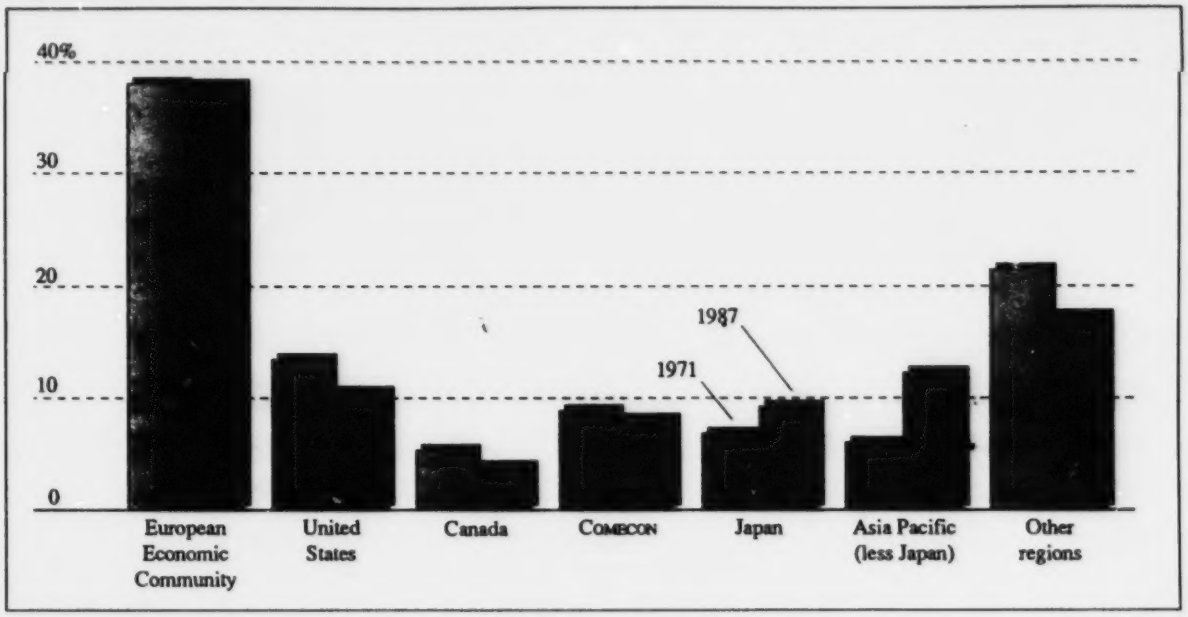
Intraregional Trade, 1971 and 1987



1 Including Mexico.
SOURCE Based on data from Statistics Canada's World Trade Database.

Chart 1-5

Regional Shares of World Exports,[1] 1971 and 1987



1 Including intraregional trade.
SOURCE Based on data from Statistics Canada's World Trade Database.

creates a big increase in the demand for savings. Thus Europe may well become a net user of world savings rather than a net provider of savings to the rest of the world, as industries invest to take advantage of post-1992 Europe, a reunified Germany, and the new opportunities in Eastern Europe and possibly also the Soviet Union.

Canada is not particularly well placed to participate in the transformations taking place in Europe, both east and west. It is handicapped by distance and by weak competitiveness in finished goods. Currently, Canada sells grain to the COMECON countries, as well as raw materials and fuels to the Asia-Pacific region; its manufacturers appear to be less and less competitive in the European Community (Chart 1-6 and Appendix Table A-1). At the same time, Canadians must recognize that more than 30 per cent of exports from the Asia-Pacific region come to North America (Chart 1-7). These countries will be competing vigorously for market share here in our own backyard.

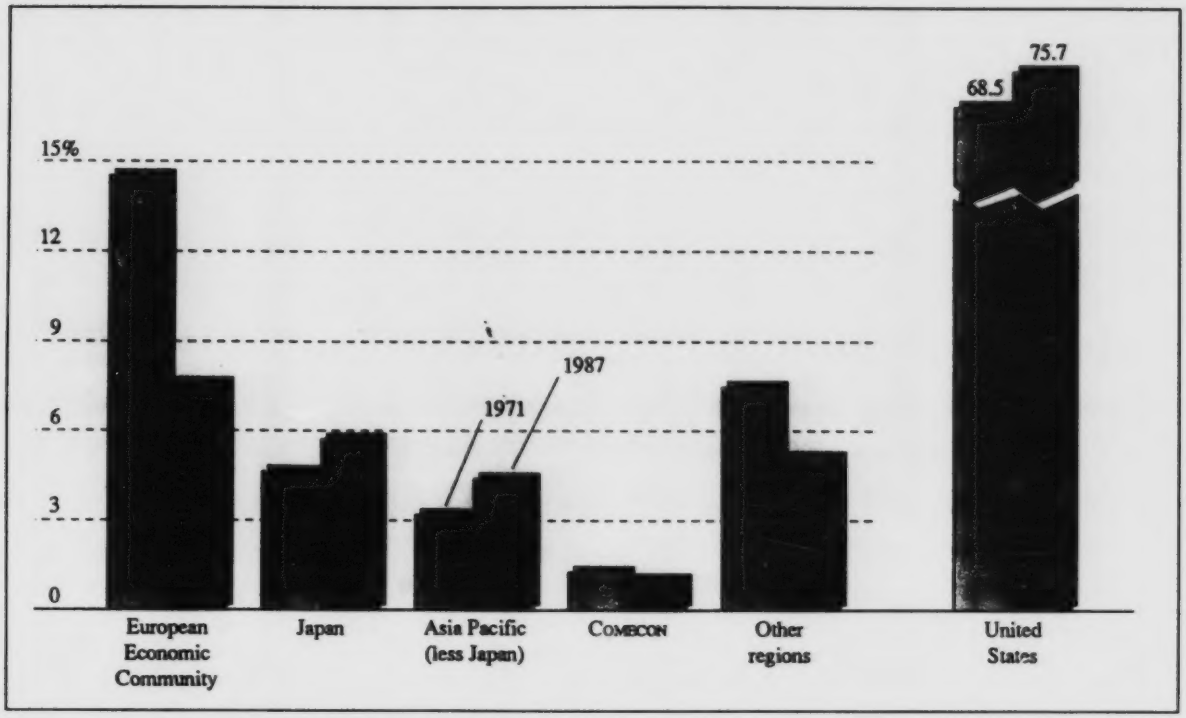
The pattern that is emerging is clear: the big markets with the greatest growth potential will be located overseas, where Canada is known mainly for its resources. Canadian firms will have to be aggressive and more competitive with respect to both cost and quality in order to take advantage of the new opportunities that will arise in all of those markets. It should be recalled here that apart from gaining secure access to the U.S. market for Canadian producers, the Canada-United States Free-Trade Agreement was intended to give them a stronger local market base from which to compete in these overseas markets. The challenge now is to ensure that Canadian firms can compete and that they have access to the rapidly growing markets overseas – a key objective in the current round of GATT negotiations.

Broadening the GATT

To date, the emergence of trading areas or regions has reinforced the expansion of world trade. Their evolution was driven by the natural affinities among countries that are tied together by geography or by common economic objectives. The GATT rules were specifically meant to provide for the formation of free-trade areas and customs unions because these were seen to contribute to trade expansion. Nonetheless, there are large volumes of so-called "managed trade" that take place outside the GATT rules, and it is now widely acknowledged that the GATT itself must be strengthened if the continued expansion of the trading system is to be assured.

Chart 1-6

Destination of Canadian Exports, 1971 and 1987



SOURCE Based on data from Statistics Canada's World Trade Database.

When the General Agreement was signed, the tariffs applied by the original 23 signatories averaged 40 per cent. Seven successive rounds of negotiations have brought the average for the current membership of 97 countries down to about 5 per cent. The Uruguay Round, now scheduled to conclude in Brussels in December 1990, could lower this average further. But even more important, it could also extend GATT rules to two areas – agriculture and services – that have been neglected until now. In agriculture and in textiles and clothing, substantial barriers to trade now exist because exemptions to the GATT rules have been used to protect producers in Europe and North America; with respect to services, investment, and intellectual property, the General Agreement is now essentially silent and must be extended to create a framework to guide these burgeoning areas of exchange between countries.

Canada has a high stake in both aspects of the current negotiations. This country's main objective in the past was to improve its access to the U.S. market. Now, with the Canada-U.S. trade agreement in place, Canada's attention is focused on improving access to 30 markets overseas, including Japan, Mexico, and Brazil. At the same time, the outcome in agriculture will have major repercussions on Canadian farmers (as well as taxpayers and consumers), and the new code pertaining to services will be important for the expansion of exports, since Canada already has a well-developed service sector. But more generally, Canada has a high stake in the Uruguay Round simply because its dependence on international trade makes it quite vulnerable to unfair trade practices. In short, it depends on the GATT principles to ensure that there will be a strong and objective referee in world markets. Success in this round of negotiations will strengthen the GATT; failure would bring such discredit that the referee might no longer be effective.

In the case of agriculture, the Uruguay Round is faced with resolving the contentious issues related to the use of export subsidies (which distort competition in international trade), quantitative restrictions (such as import quotas), and other nontariff barriers (such as health and sanitary regulations) that restrict market access. But subsidies, quotas, and restrictive regulations are but one step away from the income-support and supply-management policies currently

being used in many countries, including Canada. They have encouraged the overproduction of farm products, distorted agricultural trade, and raised the price to consumers of agricultural products. In budgetary terms, domestic farm-support programs around the world now cost consumers and taxpayers about US$250 billion a year. In Canada, direct transfers to farmers amounted to about two fifths of the value of agricultural output in 1989, according to a recent GATT report.[3]

The main stumbling block to an agreement on agriculture so far has been the high domestic political cost of phasing out farm-support programs. The cost would be extraordinarily high in the case of the Common Agricultural Policy (CAP), for example, which is a cornerstone of the European Community. This issue is also a highly sensitive one in Canada: the export-oriented farmers on the Prairies want to see trade barriers fall, while those in Ontario and Quebec – who are the beneficiaries of supply-management systems – depend on barriers to imports from abroad.

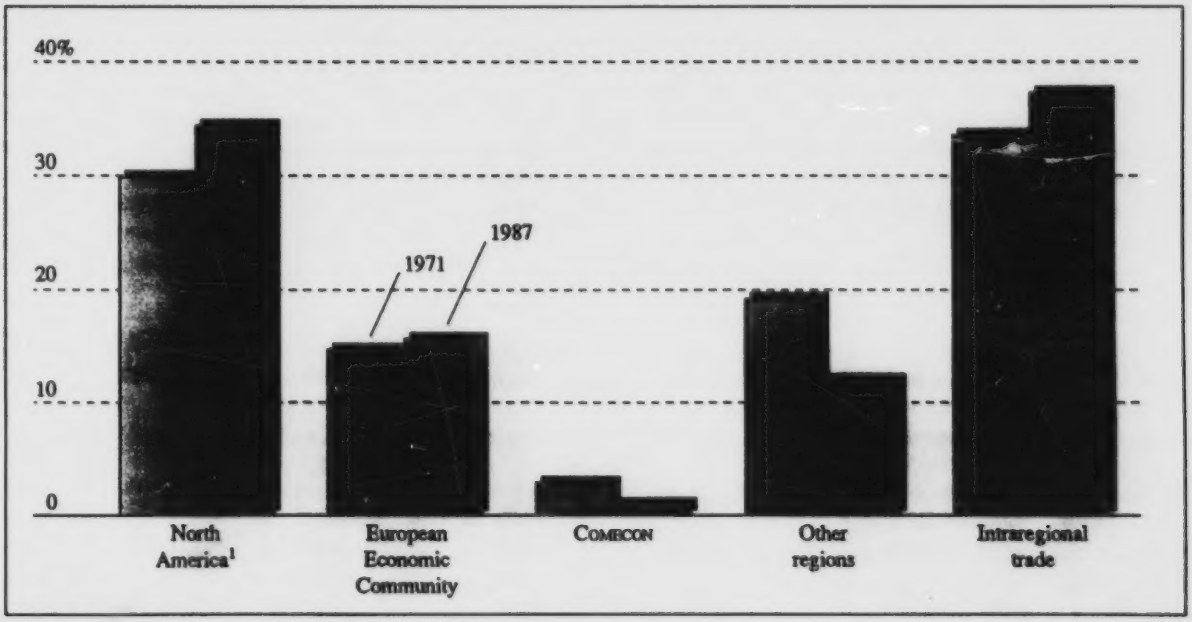
The Uruguay Round is also facing the complicated problem of establishing a separate General Agreement on Trade in Services (GATS). In contrast with the situation in agriculture, there is a good deal of general support for the GATS framework among both developed and developing countries. Trade in services rests on the movements of people, information, and investment among countries and thus has spawned expansion in areas such as tourism; computer and software services; consulting, engineering, architectural, and construction services; telecommunications; transportation; insurance; and financial services. The challenge is to apply the four basic principles of the current GATT framework to trade in services – i.e., most-favoured-nation treatment, transparency of national rules, equal treatment under national rules, and the progressive lowering of trade barriers through successive rounds of negotiations.

Failure to achieve a comprehensive agreement in the crucial meetings scheduled for December would put the world trading system at some risk, with particularly damaging consequences for small and medium-sized powers like Canada. The absence of a strengthened GATT framework would encourage countries to try to deal with trade issues bilaterally or through trading blocks. In either case, the risk is that the trading partners left out of the discussions will suffer and that punitive or intrusive demands could be made by a stronger trading partner against a weaker one.

One example of bilateral arm-twisting is the recent outcome of the Structural Impediments Initiative between the

Chart 1-7

Destination of Asia-Pacific Exports, 1971 and 1987



1 Including Mexico.

SOURCE Based on data from Statistics Canada's World Trade Database.

United States and Japan. In essence, the United States argued that Japanese nontariff barriers in agriculture and in the trade and distribution sector were making it next to impossible for competitive forces to improve the trade position between the two countries. Japan complained that the mix of U.S. monetary and fiscal policies was inappropriate. Thus, Japan claimed, a smaller fiscal deficit and higher taxes were needed to bridle the U.S. taste for imported goods. In other words, the two countries were not negotiating about trade policy but about the way their economies function and how they are regulated.

The agreement between the United States and Japan that was announced in May 1990 is extraordinary, because each partner has intruded deeply into the fiscal affairs of the other. The United States has promised to raise taxes, cut its budget deficit, and raise its savings rate; Japan has promised to invest in public infrastructure and raise consumption. If highly intrusive bilateral solutions can occur in the middle of the Uruguay Round, they can only be encouraged by the failure of the multilateral process. What would be the impact of failure on the world trading system? The existence of three trading blocks, dominated by Japan in Asia, by the United States in North and South America, and by Germany in Europe, raises the possibility that these regions might turn inward. In that event, comparative advantage would be allowed to determine trade flows only within each block, while interregional trade would be depressed, resulting in fewer gains in global efficiency.

Implications for Canada

Whatever the outcome of the Uruguay Round, it is clear that Canadian producers of goods and services face a decade of dramatic change in the markets they will serve and in the competition they will face both in Canada and overseas.

Just how ready are Canadians for these new economic realities? And what policy challenges are they likely to face? In one sense, it is fair to say that Canada has been trying to get its house in order for stronger global competition. Both the Canada-United States Free-Trade Agreement and the goods and services tax have been controversial, but both are aimed directly at improving the environment for exporting and import-competing firms. Nonetheless, there are other domestic policy areas where Canada is much less well-prepared. The federal fiscal deficit, for example, severely handicaps the federal government's margin for manoeuvre in adopting any new expenditure or tax initiatives to help Canada compete. It also means that the cost of capital in Canada is higher than it would otherwise be. In addition, the cost of Canadian goods and services has been badly distorted by the high value of the dollar and by higher prices for regulated goods and services (see Chapter 2).

Trade and Jobs

All of these cross-currents on the world scene have had a real and dynamic effect on workers in Canada.[4] While we cannot predict how trade flows will change in the 1990s, it is quite instructive to observe the way in which trade and technology altered the jobs available to Canadians during the 1980s.

Our analysis uses Statistics Canada's input-output data for 1981 and 1986 (the most recent year available) to assess the factors that add to, or subtract from, employment in different industries. These factors include the growth in exports, the composition of those exports, the growth and composition of imports, and changes in technology that affect the composition of the inputs to production – new materials, for example, or the process of production itself. The analysis is partial, however; it isolates the direct impacts on employment but does not account for the indirect effects of changes in income.

It is important to note that the changes reported here occurred within the context of a dramatic improvement in Canada's trade position. Export volumes increased by $34 billion between 1981 and 1986, while import volumes increased by $24 billion. By 1986, Canada was exporting the equivalent of 32 per cent of real GDP, up from 27 per cent in 1981. This process of specialization and integration continued at a slower pace until 1989, when exports accounted for 33 per cent of production.

The first conclusion to be drawn from Table 1-2 is that the net effect of these pressures did little to change total employment in Canada: the net change reported in column 8 is only 5,000 jobs. The second conclusion is that the change in the composition of employment was quite remarkable: in manufacturing, 80,500 fewer workers were required, while in services and other industries, 113,700 more workers were required. Employment in the primary sector declined by 38,400.

These figures, in turn, mask even greater changes at the industry level (see Appendix Table B-1). As Canada became more integrated into the world economy, the need for manpower declined in industries like textiles, clothing, machinery, electrical products, and chemicals, but manpower requirements increased in wood, paper, printing, and transportation equipment. These changing patterns also strongly reinforced the trend towards a service economy, particularly business services. This may appear

Table 1-2

Impact of Change in Trade and in the Composition of Inputs on Employment, Canada, 1986/81[1]

	Total employment, 1986 (1)	Impact of change in: Composition of inputs (2)	Export level (3)	Export composition (4)	Import level (5)	Import composition (6)	Impact of interaction effect (7)	Total impact (8)
				(Thousands of workers)				
Primary	729.8	–39.3	104.6	–73.9	–61.4	24.6	7.0	–38.4
Manufacturing	1,804.0	29.9	299.6	73.9	–330.2	–146.2	–7.4	–80.5
Other industries	6,028.0	12.6	258.9	–5.3	–183.3	51.2	–20.3	113.7
Total	8,561.8	3.2	663.1	–5.3	–575.0	–70.5	–20.7	–5.2

1 The table measures the number of additional workers required as a result of changes in a number of factors between 1981 and 1986. If a given product requires a different mix of intermediate inputs in its manufacture, this will influence the industrial composition of the labour content of the final product. The impact on worker requirements of changes in the level and industrial composition of final demand (including exports and imports) can also be assessed. These calculations should not be confused with those obtained from a macro-econometric model, where a fully integrated income effect is also taken into account. These results are associated only with the direct and indirect effect of intermediate and final demand change on worker requirements. See Appendix B for additional explanations.

SOURCE Estimates by the Economic Council of Canada, based on Statistics Canada, Input-Output Tables, 1981 and 1986.

odd at first, since few services are traded. The explanation is that tradable goods now have a higher service content, especially in the business-service sector, where demand transmitted from the tradable-goods sector gave rise to an increase in requirements of more than 48,000 workers.

The Council Statement, *Good Jobs, Bad Jobs*, examined the linkages between the service and manufacturing sectors and concluded that a higher indirect service content is found in many of the goods that Canadians produce today. The statement therefore argued that a prerequisite for a competitive manufacturing sector is a healthy service sector.

Columns 3 and 4 of Table 1-2 isolate the impact of exports. The rising volume of exports (column 3) caused a dramatic increase in manpower requirements in the primary, manufacturing, and service sectors. But even though Canada exported more, some product sales grew faster than others. This changing mix of exports increased employment in manufacturing by 74,000 but produced a decline in the primary sector.

On the import side, the increased volume of imports reduced worker requirements from what they might otherwise have been (column 5 of Table 1-2). Meanwhile, the compositional change in imports raised employment in the service sector by 51,000 (column 6), as the new mix of imports required more inputs from transportation, distribution, and business services.

Looking at the composition of inputs or the process of production itself, we find important changes in the material content of goods (plastics replacing metals, for example) and in the value of the services embodied in them (software used in production or warranties included in the price of a car). Both are examples of technological change. Column 2 of Table 1-2 indicates what employment would have been in 1986 if the production inputs of 1981 had been used to produce the products that Canadians bought and exported in 1986. One striking result is evident. About the same number of workers are needed if old inputs are used, as opposed to new ones; but, again, the composition is very different; changing technology reduced employment in primary industries but raised it in manufacturing and services. There are also big shifts within manufacturing, with worker requirements being sharply reduced in the metals industries (see Appendix B).

This analysis demonstrates how much of the ongoing change in labour markets can be explained by shifting patterns of trade and changes in technology. Clearly, the volume and mix of the goods that Canada sells abroad have a direct bearing on the jobs available to its residents. Workers, therefore, have a direct interest in this country's ability to produce goods and services at a price and quality that appeals to customers in other countries. They also have a direct interest in Canadian access to those markets through trade negotiations. At the same time, these shifts in trade and technology have created substantial pressure on

workers – pressures that have led them to change jobs and/or to make adjustments in the content of their work. Our assessment of the new global realities in the 1990s leads us to believe that the composition of employment will continue to change at a rapid pace. Thus one of the crucial policy issues for the 1990s will be the capacity of industries and workers to adapt to change.

Interest Rates

Another fundamental factor in the overall economic picture will be the impact of the new economic realities on the level of real interest rates. This is critical to industry, governments, and individuals – especially in a debtor country like Canada.

Interest rates have declined substantially in major industrialized countries since the beginning of the 1980s, reflecting a better inflation performance in these countries over the decade. However, real interest rates, as measured by the difference between short-term nominal interest rates and inflation, have been high relative to their levels in the 1970s. Moreover, as shown in Table 1-3, these short-term real rates began to rise in many countries during 1988.[5]

For a net debtor country like Canada, a worldwide increase in real interest rates results in a transfer of real income to foreigners and thus leads to a decline in domestic consumption. A rise in interest rates also has consequences for the distribution of income within Canada: debtors see the cost of servicing their debt increase, whereas creditors enjoy a rise in real income; in addition, the cost of capital increases relative to the cost of labour.

Two factors help to explain the high worldwide interest rates that prevailed during the 1980s. First, a tight monetary policy was combined with an expansionary fiscal stance; business investment was crowded out by public borrowing, a situation that could lead to lower future output and income. Second, investment was stimulated by supply-side measures – such as lower corporate taxation, deregulation of trade among and within nations, technological innovation, greater specialization, better business management, and so on. Eventually, this should lead to an increase in potential output and in income per capita.

Because financial capital is free to move across borders, the expected real rate of return on investment tends to be similar across countries. This means that no country can insulate itself from worldwide movements in real interest rates. However, the latter are not necessarily identical in all countries at all times. They might differ simply because exchange rates are expected to vary or because monetary policies vary from country to country.

What are the prospects for real interest rates in the industrial countries over the period 1990-95? Some downward pressure on real rates is possible. Under the assumption of continuing moderate economic growth (the base-case assumption analysed in Chapter 2), government borrowing should continue to decline gradually in most countries. If that is the case, the supply of savings as a proportion of GNP in the industrialized countries will likely be larger than it was during the 1980s, when the supply of savings was well below the norm for recent decades (Chart 1-8). This outcome is contingent upon the pace of economic growth and upon fiscal decisions made in the United States, where the Congress and the Administration are now seriously considering a budget package but are also facing extra military outlays in the Middle East. (Trends in government borrowing since 1970 are shown in Chart 1-9.)

Upward pressure on real interest rates will come from two other sources. The first is the combined impact of European integration, German reunification, and economic renewal in the Soviet Union and Eastern Europe. The recent rise in German interest rates has already had repercussions on financial markets around the world, including Japan and North America. The second source of pressure lies in the determination of central banks to avoid a costly acceleration of prices, as most industrial countries are now operating at close to full capacity. The Bank of Canada, in particular, has unambiguously reaffirmed its determination not to tolerate a rising price level and has set a goal of price stability over the long term.

On balance, therefore, it seems likely that global real rates of interest will remain high – above 5 per cent – during the first half of the 1990s. The level in Canada could be higher, depending on the stance of monetary policy and the pressures on the Canadian dollar.

Conclusion

We have portrayed a world economy that is being transformed very rapidly. We have also documented how shifts in the patterns of trade can affect the jobs available to Canadian workers and how the global balance between savings and investment can affect the level of interest rates in Canada. Whether we like it or not, Canada is part of a world economy that imposes discipline and constant change on its inhabitants. If we are to borrow capital from abroad, we must pay the going interest rates. If we are to compete in export markets, we must offer the quality and prices for

Table 1-3

Inflation and Interest Rates, Group of Seven, 1961-89

	Averages											
	1961-69	1970-79	1980-89	1981	1982	1983	1984	1985	1986	1987	1988	1989
						(Per cent)						
Canada												
Inflation rate[1]	3.0	7.7	5.6	10.8	8.7	5.0	3.1	2.6	2.4	4.4	4.1	4.8
Short-term interest rate	4.6	7.0	11.5	18.3	14.1	9.5	11.2	9.6	9.2	8.4	9.7	12.2
Deflated interest rate[2]	1.6	–0.7	5.9	7.5	5.5	4.4	8.1	7.0	6.8	4.0	5.6	7.4
United States												
Inflation rate[1]	2.8	7.0	4.9	9.6	6.4	3.9	3.7	3.0	2.6	3.2	3.3	4.1
Short-term interest rate	4.7	7.3	9.9	15.9	12.3	9.1	10.4	8.0	6.5	6.9	7.7	9.1
Deflated interest rate[2]	1.8	0.2	5.0	6.3	5.8	5.2	6.6	5.1	3.9	3.7	4.4	5.0
United Kingdom												
Inflation rate[1]	3.9	12.7	7.5	11.4	7.6	5.3	4.6	5.6	3.5	5.0	6.5	6.7
Short-term interest rate	5.6	9.2	12.0	13.9	12.3	10.1	9.9	12.2	10.9	9.7	10.3	13.9
Deflated interest rate[2]	1.7	–3.5	4.5	2.5	4.7	4.8	5.3	6.6	7.4	4.7	3.8	7.1
France												
Inflation rate[1]	4.3	8.9	7.1	11.4	11.7	9.7	7.5	5.9	5.0	2.8	3.0	3.4
Short-term interest rate	5.0	8.4	11.0	15.3	14.6	12.5	11.7	9.9	7.7	8.3	7.9	9.4
Deflated interest rate[2]	0.7	–0.5	3.8	3.9	2.9	2.7	4.2	4.1	2.7	5.4	4.9	6.0
Germany												
Inflation rate[1]	3.2	5.6	3.0	4.0	4.4	3.3	2.0	2.2	3.1	2.0	1.5	2.5
Short-term interest rate	3.6	6.0	6.4	11.3	8.7	5.4	5.5	5.2	4.6	3.7	4.0	6.6
Deflated interest rate[2]	0.3	0.4	3.4	7.2	4.3	2.1	3.6	3.0	1.5	1.7	2.6	4.1
Japan												
Inflation rate[1]	5.3	7.9	1.6	3.2	1.9	0.8	1.2	1.4	1.8	–0.3	0.6	1.5
Short-term interest rate	8.2	7.3	6.1	7.4	6.9	6.4	6.1	6.5	4.8	3.5	3.6	4.9
Deflated interest rate[2]	2.9	–0.6	4.5	4.3	5.1	5.6	4.9	5.1	3.0	3.8	3.1	3.3
Italy												
Inflation rate[1]	4.3	13.4	11.6	18.6	17.1	14.9	11.4	8.9	7.7	5.9	6.2	6.3
Short-term interest rate	6.3	10.4	15.7	19.6	20.2	18.4	17.3	15.2	13.4	11.5	11.3	12.7
Deflated interest rate[2]	2.1	–3.1	4.1	1.0	3.1	3.5	5.8	6.4	5.7	5.6	5.1	6.4
Average												
Inflation rate[1]	...	...	...	...	6.9	4.7	4.0	3.4	3.0	2.7	3.0	3.6
Short-term interest rate	...	...	...	...	11.8	9.3	9.7	8.4	6.9	6.7	7.2	8.7
Deflated interest rate[2]	...	...	...	...	4.9	4.6	5.7	5.0	3.9	4.0	4.2	5.1

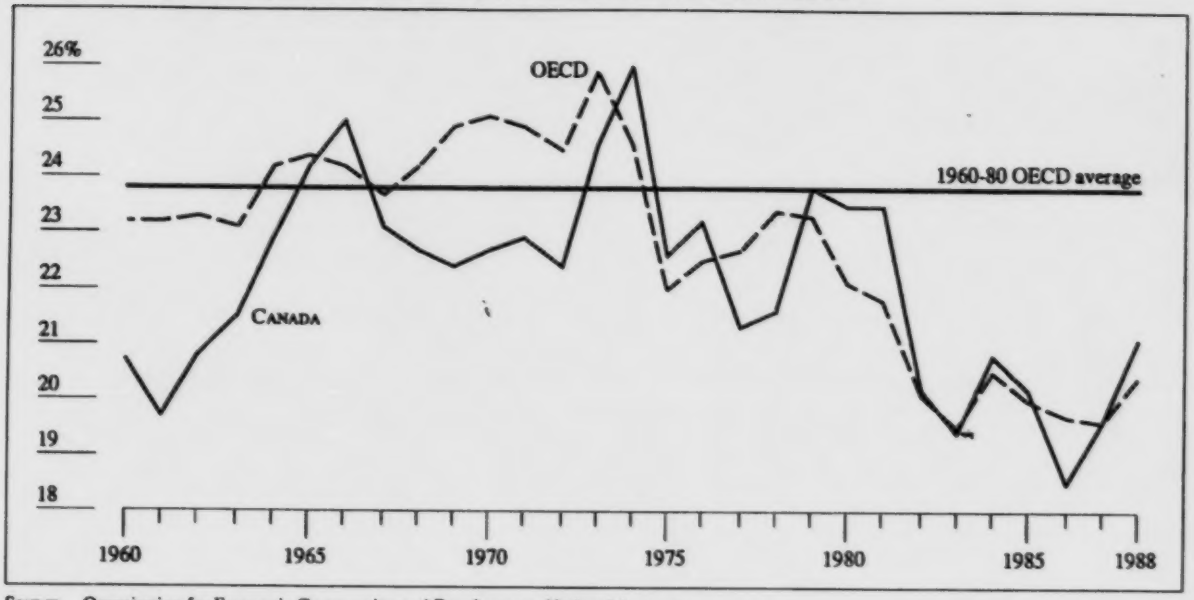
1 Change in GNP/GDP deflator.

2 Calculated as the short-term interest rate minus the inflation rate.

SOURCE Wharton Associates; and International Monetary Fund, *World Economic Outlook* (May 1990).

Chart 1-8

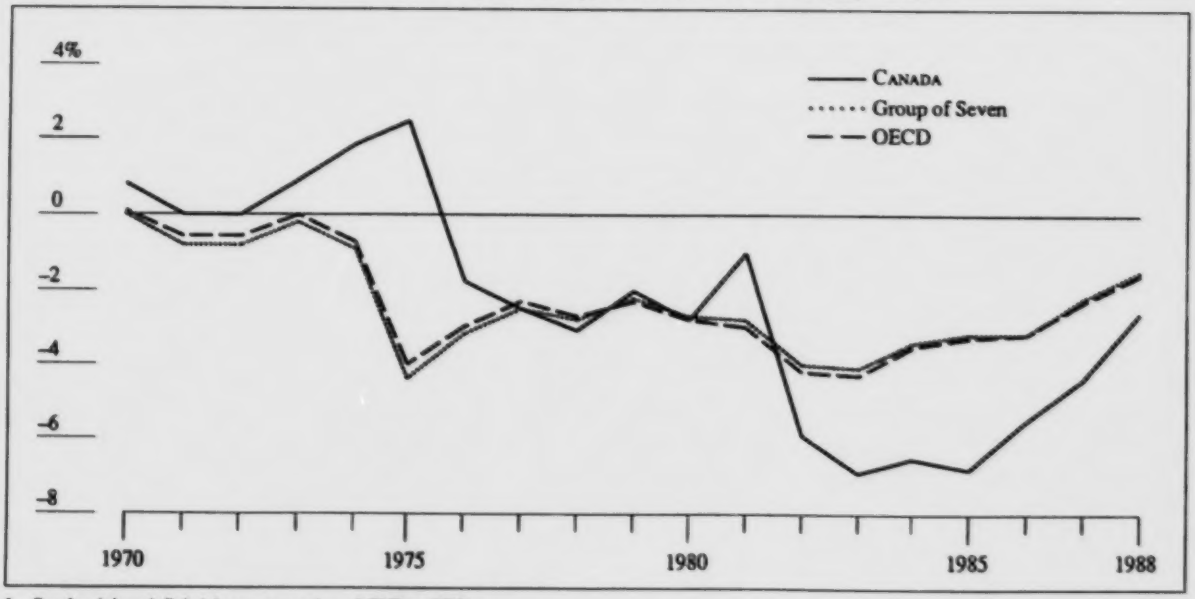
National Savings as a Proportion of GNP or GDP, Canada and OECD Area, 1960-88



SOURCE Organisation for Economic Co-operation and Development, *National Accounts*.

Chart 1-9

General Government Financial Balances,[1] Canada, Group of Seven, and OECD Area,[2] 1970-88



1 Surplus (+) or deficit (–) as a proportion of GNP or GDP.
2 Excluding Iceland, Luxembourg, New Zealand, Switzerland, and Turkey.
SOURCE Organisation for Economic Co-operation and Development, *Economic Outlook* (June 1990).

goods and services that others wish to buy. If we wish to ensure access to other markets, we must offer access to our own markets.

The early 1990s will not be an easy time for Canadians. There is distinct evidence of slowing economic growth. Our society is divided on constitutional issues, and the failure of the Meech Lake Accord in June has created a whole new set of question marks about how Canadians wish to be governed and to organize their society. Opinion is also deeply divided on controversial policy proposals such as the goods and services tax and amendments to the Unemployment Insurance Act. Recent Council documents have revealed the increasing inequality of income distribution as a result of the polarizing job structure into "good jobs" and "bad jobs."

These are times when it will be difficult to build consensus, to infuse Canadians with the sense that they have much to gain from understanding and adapting to the new international realities. An assessment of the medium-term outlook for the Canadian economy and of the troublesome issues of inflation and unemployment will provide some insights into the causes of these difficulties.

2 Canadian Tradeoffs

Introduction

Whatever happens elsewhere during the 1990s, Canada has already committed itself to making two major policy changes. The first is a rethinking of the way this country trades with the rest of the world – a change that requires gearing up for freer trade with the United States and possibly for the new rules emanating from the Uruguay Round of the GATT, and adjusting to a reformed sales tax based on value-added principles. The second change involves the struggle to reduce the federal deficit. Unfortunately, the sudden and unexpected increase in world interest rates in early 1990, followed by a jump in oil prices during the summer, is making the transition more difficult in both instances.

In *Legacies*, our 26th Annual Review, we were preoccupied with the degree to which Canadians were "passing the buck" to future generations.[1] We pointed to the size of the federal deficit, the soaring federal debt, and a growing dependence on foreign capital. In effect, as a nation, Canadians have been spending more than they have been producing. At the same time, we pointed out the need for action against environmental damage and for investment to improve Canada's productive potential.

In this year's Review, we find Canada trapped in a set of unattractive short-run tradeoffs. In late 1988 and early 1989, after six years of expansion, economic performance in Canada had reached its potential. After a period of very high capacity utilization, the manufacturing sector has slowed to a standstill. But inflationary pressures have now emerged in other sectors. In turn, the general upswing in prices has provoked a tightening in monetary policy that has had unfortunate consequences for the federal government's fiscal position, as high interest rates add to the cost of servicing the federal debt. Thus we have reached a stage in the business cycle where the global trend towards high interest rates and the Bank of Canada's policy of restraint have the effect of increasing the deficit and raising unemployment.

To examine what possibilities exist for pulling Canada out of its present dilemma, we explore the tradeoffs between different policy strategies by asking a number of "what if" questions. Using an econometric model, we assess the way in which certain policy choices would affect the economy over the next five years, assuming in some cases that economic decisions (on prices, wages, investment, and so on) will be made, on average, along the same lines as in the past. In other instances, we modify economic behaviour, particularly with respect to wages and prices. The questions posed in the chapter are:

- What would be the consequences of a sharp spike in interest rates if the strength of demand led Canadian monetary authorities to take a more cautious approach towards inflation pressures?

- What would a sharp recession mean for Canada during the current period of adjustment?

- What would be the implications of reaching an interim target of 3 per cent for inflation if wages and prices were more flexible?

- How much has the fiscal action of recent federal budgets actually contributed to deficit reduction?

- What would be the impact of an easier monetary policy?

In past Annual Reviews, the Council's base case projected the most likely scenario for the economy over a medium-term future of three to five years, given the existing policy regime and the most likely evolution of external factors. Since last year's Review, the world economy has been subjected to an extraordinary array of cross-currents. At the same time, the Canadian economy is poised between a slowdown and a recession. Accordingly, we present in this Review a base case where the potential damage associated with the current danger signals is kept under control. The base case projects slow growth in 1990 and 1991, followed by a return to the potential growth path of the economy for the period 1992-95. The damage is controlled by three factors. First, economic growth in the United States is assumed to average about 2 per cent in 1990 and 1991 (that is, slow growth but no recession), while activity remains strong in Europe and Japan. The indicators for the United States are set out in Appendix Tables C-1 and C-2. Second, oil prices are expected to rise slowly but steadily to about US$23/barrel by 1995, as OPEC becomes more

stringent in controlling production levels once the situation in the Middle East stabilizes. (In Appendixes C and D, we examine the impact of the recent sudden increase in oil prices caused by the invasion of Kuwait by Iraq.) Third, the policy environment here in Canada includes, among other things, implementation of the goods and services tax (GST) in January 1991 and a decline in interest rates later that year. Before describing the projections, we review wage and price trends and the pressures on monetary policy.

Price and Wage Trends

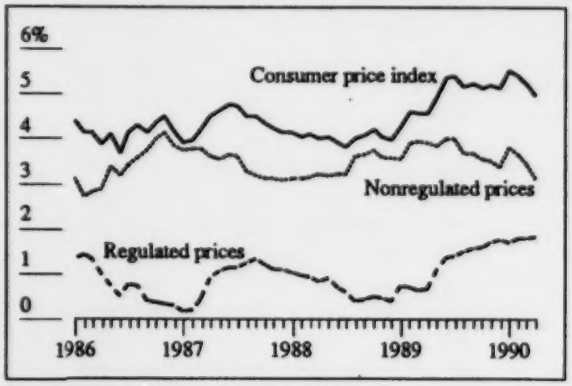
Operating at close to full capacity generated price pressures in manufacturing as early as 1987. In fact, the rate of increase in industrial prices in the manufacturing sector peaked in early 1988. However, the rest of the economy continued to operate at high rates of utilization until 1990. Chart 2-1 shows that the main source of upward momentum in the rate of inflation since mid-1989 has been regulated prices, especially in the service sector. Included in this category are the prices that are directly influenced by federal, provincial, and municipal policies with respect to such areas as public transportation, communications, energy, water utilities, food products controlled by marketing boards, property taxes, and items such as alcohol, tobacco, and gasoline, where a large portion of the selling price is made up of federal and provincial levies. The largest increases since early 1989 have affected gasoline prices, vehicle registration fees, tobacco and alcohol, public transportation, and water rates. Although residential property taxes carry a weight of only 2.8 per cent in the consumer price index (CPI), over the past two and a half years the increase in this component has been 6.3 per cent, compared with 4.7 per cent for the CPI as a whole (Chart 2-2).

Instability in the Middle East and the prospect of higher world oil prices will also put upward pressure on domestic prices in the coming year, although assessing the force of that pressure was difficult at the time of writing. Canadian prices for oil and other fuels are now highly sensitive to conditions in world markets (Chart 2-3), so that higher world prices, if they are sustained, will make the transition from higher to lower rates of inflation more difficult.

On the wage front, current negotiations are complicated by the new pressures on employers and employees resulting from changes in government payroll charges. All employers have had to face a higher total wage bill in the past year because of higher unemployment insurance premiums, reflecting a shift in the financing of the UI system from the federal government to employers and employees. Those in Ontario and Newfoundland have also been hit by new provincial payroll taxes to finance health-care services. Meanwhile, employees have been asking for higher wages because they fear the impact of the implementation of the GST in 1991.

Chart 2-1

Contribution of Regulated and Nonregulated Prices to the Consumer Price Index, Canada, 1986-90



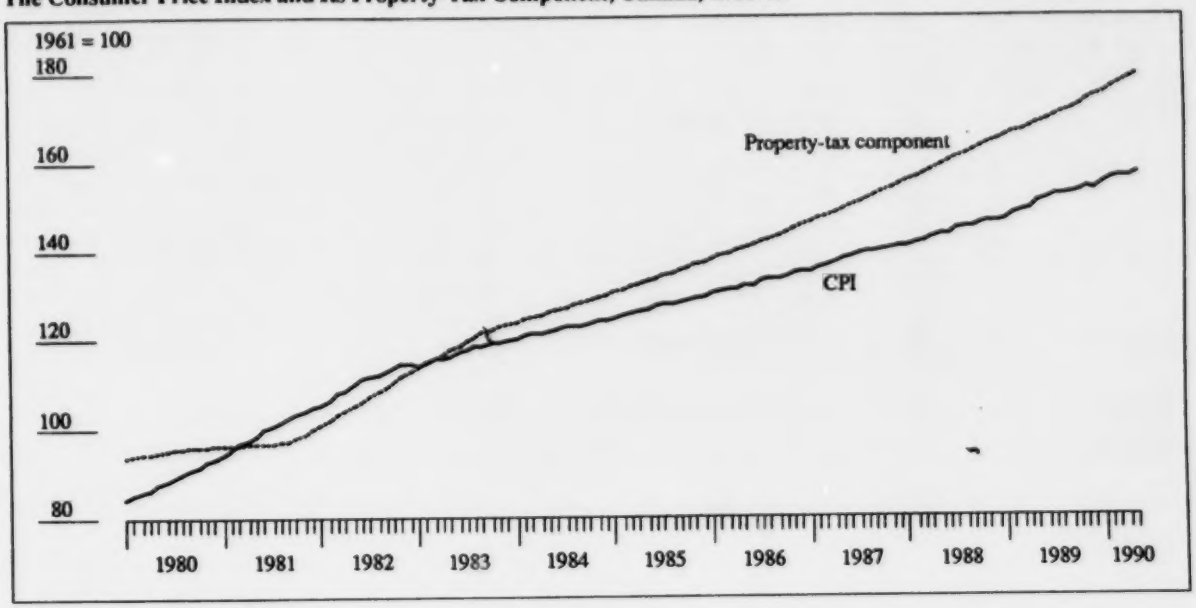
SOURCE Based on data from Statistics Canada.

The current year is one that will be marked by extensive renegotiation of labour contracts. About one million workers – twice the number recorded in 1989 – will be directly affected by the outcome of major collective agreements in the public and private sectors (Chart 2-4). The bulk of the increase over last year is occurring in the private sector. Indeed, at the time of writing, workers at two of the country's largest steel producers were on strike, and negotiations were taking place in the auto industry.

But 1990 is also an important bargaining year in the public sector. Here, wage increases lagged behind those in the private sector during the period 1987-89. But in 1989 there was a notable wage increase at the provincial level. Chart 2-5 shows that in terms of the effective increase in base rates, the provincial public sector now leads both the private sector and the federal public sector. For example, Ontario settlements led to an increase in base rates of 7.1 per cent during the first half of 1990, while increases in British Columbia averaged 6.8 per cent during the second quarter of 1990. By comparison, base rates in the federal public sector rose by only 4.7 per cent during the past four quarters. The major public-employee contracts up for negotiation in 1991 are at the federal level.

Chart 2-2

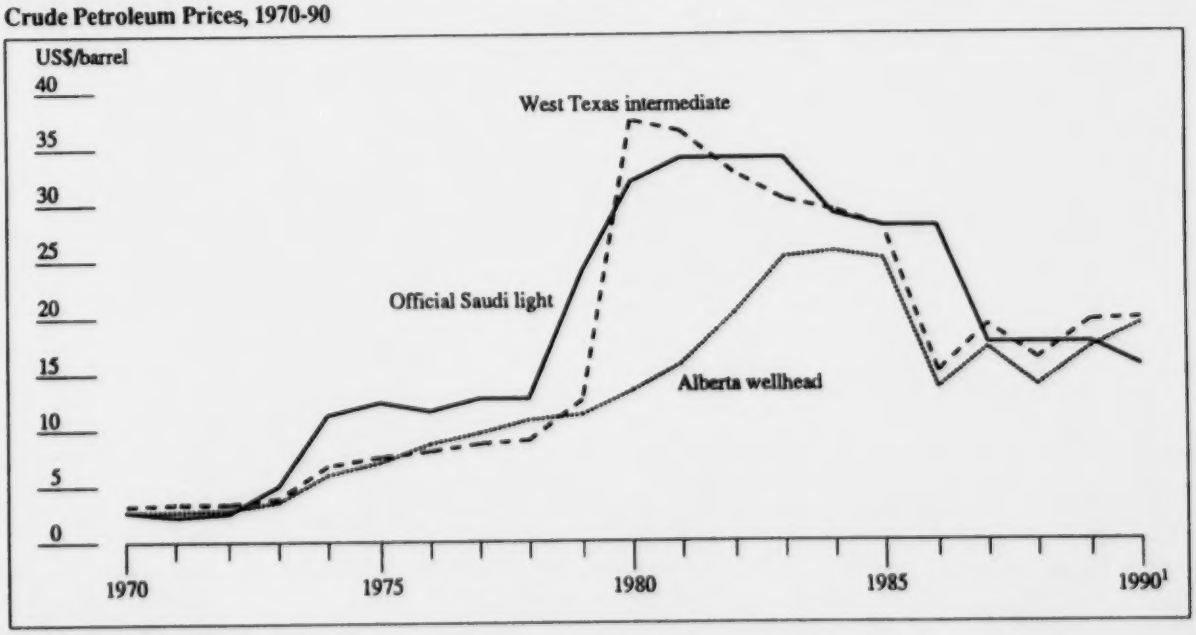
The Consumer Price Index and Its Property-Tax Component, Canada, 1980-90



SOURCE Data from Statistics Canada.

Chart 2-3

Crude Petroleum Prices, 1970-90

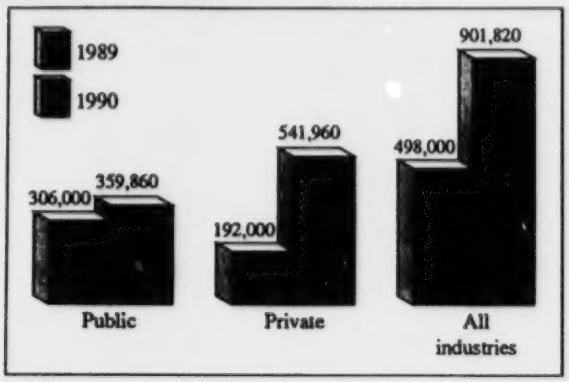


1 January to July average.

SOURCE Data from the Canadian Energy Research Institute.

Chart 2-4

Number of Employees Covered by Major Collective Agreements[1] Expiring in 1989 and 1990 in the Public and Private Sectors, Canada



1 Major agreements are those involving 500 or more employees.
SOURCE Data from Labour Canada.

Wage gains that are consistent with productivity growth are not inflationary, but if wage increases consistently run ahead of productivity gains, labour costs will rise. In the private sector, this can put upward pressure on prices or encourage employers to reduce the wage bill by cutting employment. Wage-setting is more troublesome in the public sector, where there is limited scope for linking wages to improvements in productivity.

Over time, the relationship between real wages and productivity in the private sector can fluctuate. In addition, real wages from the producer's point of view are not necessarily the same as they are to a consumer.[2] As a consumer, the worker looks at the wage he/she receives relative to what he/she pays for goods and services. Producers look at the wages they pay relative to the price they receive for the products and services they sell. Producer prices can differ from consumer prices because of the imposition of indirect taxes, subsidies, and fluctuations in export and import prices. Chart 2-6 shows that real wages from the worker's point of view have fallen behind the rate of growth of productivity since 1978, although recently there has been some catch-up. From the producer's point of view, growth in real wages has been roughly in line with growth in output per person-hour over the period 1976-89. Thus pressure on producer prices is mounting from the wage side even though productivity growth has been strong in the late 1980s. From the worker's point of view, real wages have not kept up with productivity growth since 1976 because intervening costs reduced purchasing power – for example, governments have raised indirect taxes. Thus, from the worker's point of view, pressure is building to raise wages.

Our new assessment of the economy's potential suggests that productivity growth in the medium run will average about 1.3 per cent annually, up significantly from previous estimates. The improvement in potential is caused by a number of factors: higher efficiency in the economy, resulting from the implementation of the GST and the Canada-United States Free-Trade Agreement; an upward revision in the anticipated rate of net immigration in the early 1990s and of the participation of women and young people in the work force; and finally, higher levels of business capital formation throughout the first half of the 1990s. This productivity growth will support real-wage increases during the decade.

Monetary Policy

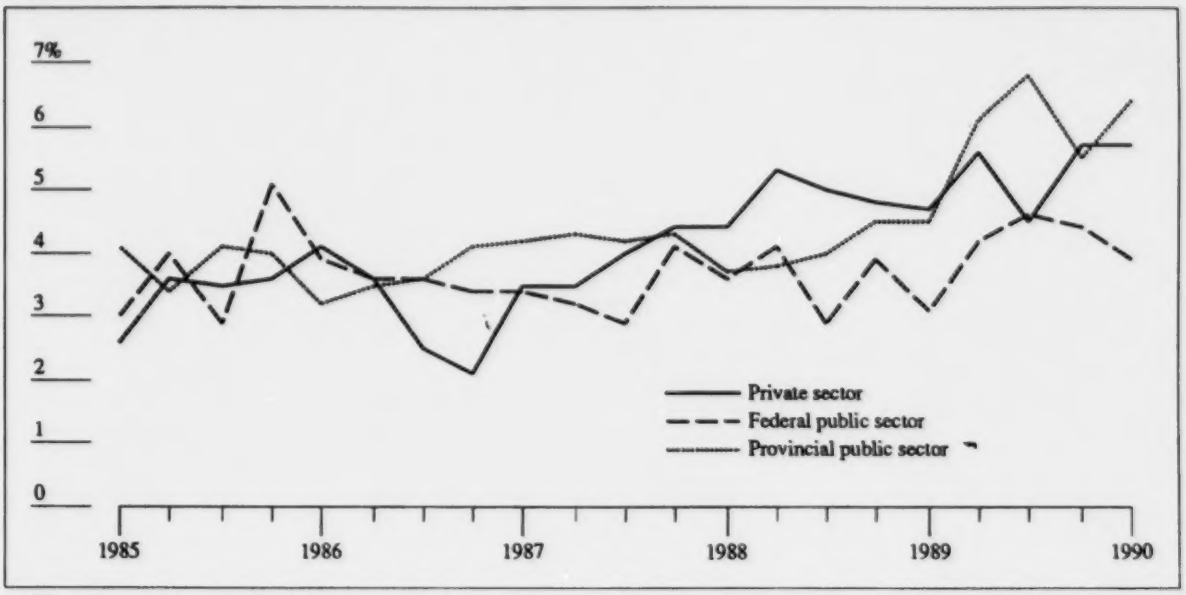
Central banks in Washington, Tokyo, and Frankfurt have stated their intention to fight inflation. They are therefore curbing growth in the money supply, thus maintaining interest rates above the levels of the late 1980s. At the same time, worldwide imbalances in trade and capital flows will continue in the coming years. Only modest progress will be made in reducing fiscal imbalances in the United States in the short run; at the same time, the need for development capital in Eastern Europe, South America, and parts of Asia and Africa will be intense. The United States, as both a debtor and a safe haven for capital, will add pressure on the worldwide supply of savings and will thus set a floor for Canadian interest rates.

One of the key determinants of interest rates in Canada is the policy stance of the central bank. This has become a source of much controversy, as the Bank of Canada's current efforts to control inflation have begun to bite in exporting industries and interest-sensitive sectors. The Bank of Canada is committed to controlling inflation. For the purposes of this Review, we have interpreted the bank's operational target as follows: to avoid a rise in the core rate of inflation in the short term, and to achieve an annual rate of 3 per cent by 1995, with some further progress down the road. Some may find this interpretation too soft, but our simulations show that it is actually quite ambitious.

The current controversy over monetary policy reflects a struggle between conflicting short-term policy priorities, and much of the debate centres around the value of the Canadian dollar. The dollar appreciated to the 87-cent (US) range during the summer of 1990 – well above the range that would be anticipated on the basis of relative rates of inflation and productivity growth. This has had positive

Chart 2-5

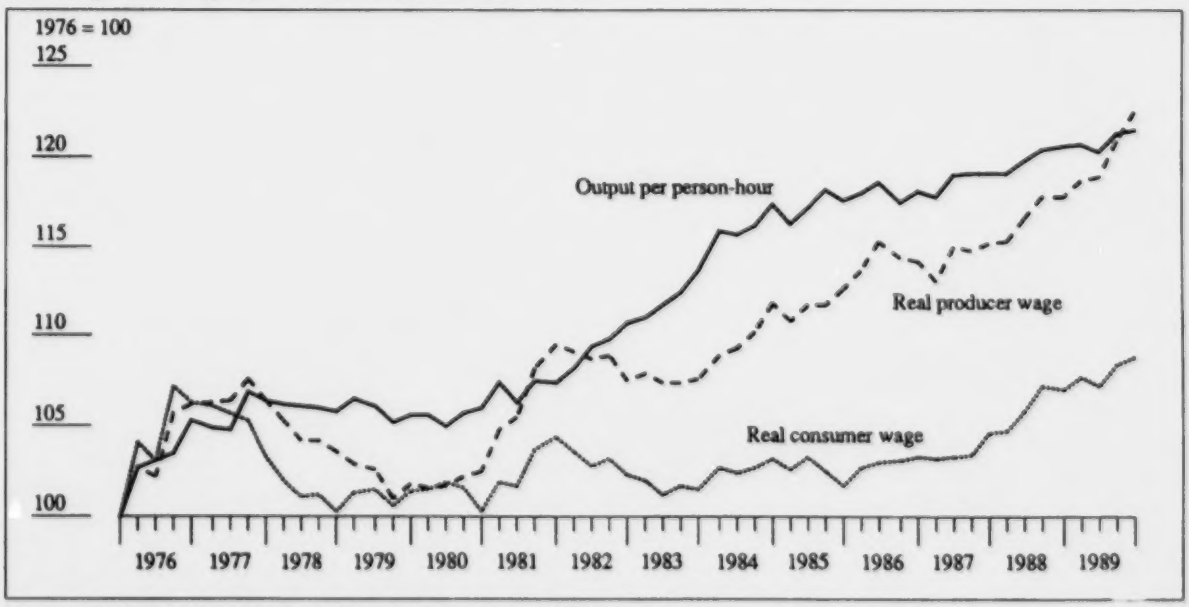
Wage Settlements[1] in the Public and Private Sectors, Canada, 1985-90



1 Effective increase in the wage base rate.
SOURCE Data from Labour Canada.

Chart 2-6

Real Wages and Output per Person-Hour, Canada, 1976-89



SOURCE Data from Statistics Canada and the Bank of Canada (August 1990).

consequences for the trend in inflation in Canada, as the high dollar has made imported goods cheaper. But in a sense, the high dollar has borrowed price stability from the future. Because there are an additional 2 to 3 percentage points of inflation waiting to emerge when the dollar returns to more normal levels, the central bank will be reluctant to see an early depreciation. In effect, interest rates will tend to err on the high side over the next few years in order to prevent a falling exchange rate from unleashing this hidden inflation.

At the same time, industry is anxious to see an early decline in the value of the dollar. A strong currency raises the price of exported goods, putting producers at a competitive disadvantage on foreign and domestic markets and discouraging the investment in plant and equipment that is needed now to modernize Canadian firms preparing for global competition in the future. There is a serious risk that, if they are sustained too long, a strong dollar and high interest rates will neutralize the positive effects of the Canada-U.S. trade agreement and other measures taken to improve this country's competitive position.

This situation has prompted some analysts to advocate that the Canadian dollar be linked by a fixed rate to the U.S. dollar. If the value of the Canada/U.S. exchange rate were to be fixed after a devaluation of, say, 10 per cent, this would, according to this argument, provide an attractive investment environment at the outset and thereafter ensure stability and certainty where neither now exists.[3]

The key benefit of a flexible exchange rate is that it acts as a shock absorber. It enables prices to adjust to shocks affecting the price of exports relative to imports and thus moderates the impact on output and employment. Fixing the exchange rate for the dollar also amounts to surrendering control over the supply of money – and hence over price levels, as Canadians would have to put up with the U.S. rate of inflation, whatever it might be. Although it is true that, on average, inflation in the United States has been somewhat lower (by about half a percentage point) than in Canada over the past 25 years, we would question whether this country ought to surrender an instrument of economic policy as important as the value of its currency to a foreign central bank. With fiscal policy already impaired by large deficits, the Canadian authorities would be unable to implement an independent choice of policy mix if monetary policy were linked to the actions of a foreign central bank.

The Base Case

According to the base-case projection, which is described in Table 2-1 and Chart 2-7, Canadian output will increase by about 1.5 per cent, on average, in 1990 and 1991. Improvement is not expected until late 1991, when a more sustainable pattern of growth in the range between 3 and 4 per cent will emerge. Thus the current situation is fragile in the short run. (A possible recession scenario is described below.)

The inflation rate, as measured by the rate of growth in the consumer price index, is expected to remain below 5 per cent in 1990 (slightly lower than the level recorded for 1989). Nevertheless, prices will increase by about 6 per cent in 1991, with about 1.3 percentage points of that increase being attributable to the introduction of the GST. Most related wage pressures will be contained because of slow growth and tight credit conditions. In the base case, world oil prices rise gradually to about US$23/barrel by 1995 – about $4/barrel more than the price in effect before tensions mounted in the Middle East during the summer of 1990. An analysis of the impact of an abrupt increase in late 1990 is provided in Appendix D. After 1991, inflation will drop to the 4-per-cent range, but in the base case no further progress is made towards reducing inflation – an issue that we shall explore further below.

We have assumed that monetary policy will remain tight for the remainder of 1990 and will begin to loosen up by mid-1991, when short-term interest rates are projected to decline to 12 per cent and then to 10 per cent – a level comparable with those recorded during the mid-1980s. Thus nominal interest rates are projected to fall by more than 3 percentage points by 1992, but real rates of interest will not fall below the 5-per-cent range during the period 1991-95. Once interest rates begin to recede, the exchange rate should return to the levels implied by economic fundamentals (such as the rates of inflation and productivity growth) relative to those of other countries. This suggests that the Canadian dollar will settle in a range within one or two cents of the 80-cent mark during the period 1992-95. The interest rates assumed in the base case are shown in Chart 2-8 along with the rates assumed in three other policy simulations discussed below. The recession case sets out the consequences of keeping interest rates high through 1991, while the other two cases explore alternative paths for monetary policy.

Employment growth will diminish in 1990 and 1991 as a result of slower growth in output. Unemployment rates will average 8 per cent in 1990-91. Real growth in the 3-to-4-per-cent range between 1992 and 1995 will return unemployment rates to what they were just prior to the 1990-91 slowdown. A rate between 7.5 and 8 per cent is consistent with a potential growth rate of 3 to 3.5 per cent.

Table 2-1

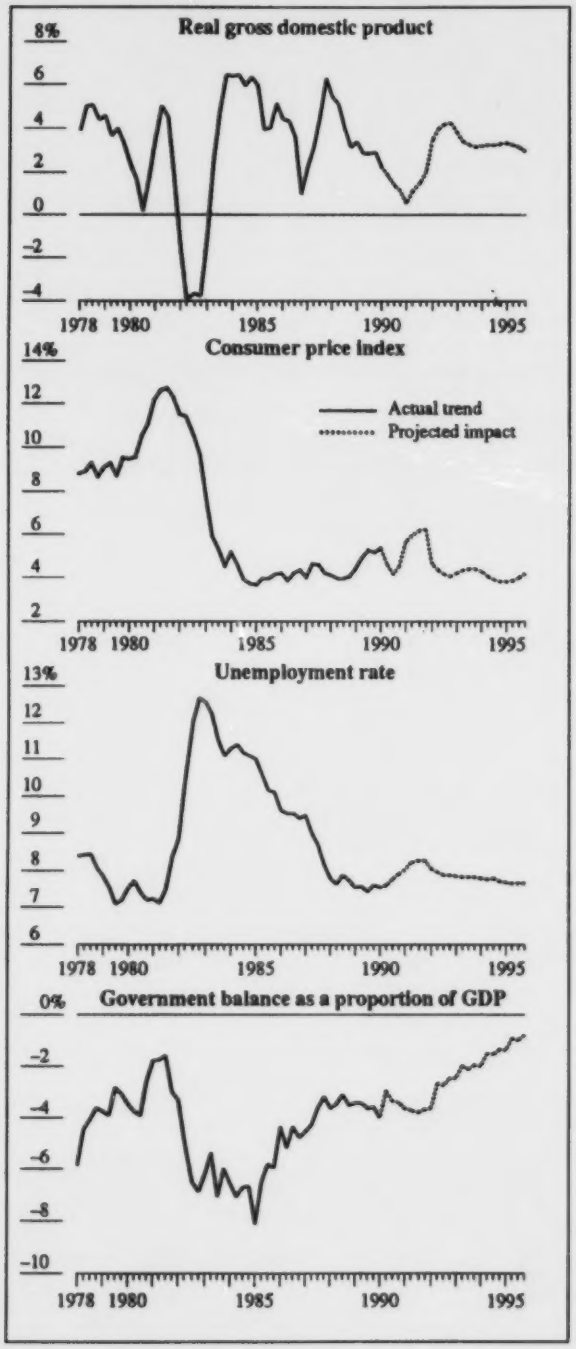
Selected Indicators of Projected Performance, Canada, 1986-95

	Actual, 1989	Projection						Average		
		1990	1991	1992	1993	1994	1995	1986-90	1991-95	1992-95
					(Per cent)					
Change in:										
Real GDP	3.0	1.6	1.3	4.0	3.4	3.2	3.1	3.3	3.0	3.4
Consumer price index	5.0	4.7	6.0	4.3	4.3	4.0	4.0	4.4	4.5	4.2
Labour force	1.7	1.3	1.3	2.0	1.8	1.9	1.8	1.8	1.8	1.9
Employment	2.0	1.1	0.8	2.3	1.9	2.0	1.9	2.4	1.8	2.0
Productivity (output per person-hour)	0.1	1.1	0.9	1.4	1.2	1.3	1.3	1.2	1.2	1.3
Real wage rate	–0.3	1.6	–1.3	1.2	0.5	1.0	1.1	–0.3	0.5	0.9
Nominal wage rate	4.6	6.4	4.6	5.5	4.9	5.0	5.1	4.1	5.0	5.1
Unemployment rate	7.5	7.7	8.2	7.9	7.8	7.8	7.7	8.3	7.9	7.8
Participation rate[1]	67.0	66.8	66.8	67.3	67.7	68.2	68.6	66.5	67.7	67.9
90-day Treasury Bill rate	12.1	13.1	12.0	10.0	10.0	10.0	10.0	10.4	10.4	10.0
US/CAN exchange rate (cents)	84.5	84.8	83.6	82.5	81.5	81.0	80.8	79.6	81.9	81.5
Level as a proportion of GDP:										
Real investment	22.0	21.9	21.5	21.3	21.6	21.8	22.2	21.4	21.7	21.7
Government balance										
Federal	–3.5	–3.4	–3.7	–2.9	–2.2	–1.6	–1.0	–3.8	–2.3	–1.9
Provincial and local	–0.1	–0.1	–0.1	–0.0	0.2	0.3	0.4	–0.4	0.2	0.2
Balance of payments										
Current account	–2.6	–2.7	–2.6	–2.1	–1.3	–1.0	–0.7	–2.1	–1.6	–1.3
Merchandise	1.2	1.0	1.1	1.2	1.3	1.5	1.7	1.6	1.4	1.4
Nonmerchandise[2]	–1.1	–1.1	–1.1	–1.1	–1.0	–0.9	–0.7	–1.1	–1.0	–0.9

1 Labour force as a proportion of population aged 15 and over.
2 Excludes net income services.
SOURCE Estimates by the Economic Council of Canada, July 1990.

Chart 2-7

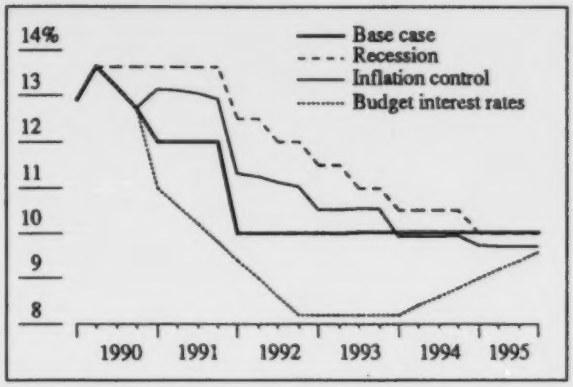
Actual Trend of Selected Economic Indicators and Projected Impact of the Base Case, Canada, 1978-95



SOURCE Data from Statistics Canada and estimates by the Economic Council of Canada.

Chart 2-8

Trend in the 90-Day Treasury Bill Rate in the Four Policy Scenarios, 1990-95



SOURCE Estimates by the Economic Council of Canada.

By the mid-1990s, employment gains will be constrained by slower growth in the labour force. A levelling-off of participation rates, in particular among prime-age women, coupled with the changing age structure, will hold labour force growth to a range between 1.5 and 2 per cent. Net immigration of 120,000 (in line with the pattern observed over the past two years) will relieve some of the pressure here. Growth in labour productivity of 1.3 per cent and labour force growth in a range near 1.9 per cent will restrict potential growth to about 3.2 per cent.

Three factors will contribute to a downward trend in the ratio of the federal deficit to GDP in the base case. First, the additional fiscal restraint introduced in the February 1990 budget will play a significant role. In addition, although the GST is expected to be revenue-neutral in its first year, a strengthening of the tax base is expected to add revenues in later years. Some part of the productivity dividend generated through the increase in efficiency that this new tax is expected to bring to market decisions should also make its way into tax revenues. Finally, interest rates should decline in 1991, thus reducing debt-servicing costs. If these trends prevail, fiscal balance will be reached after 1995, though the outcome depends upon the continuation of fiscal restraint and the implementation of all of the measures related to taxation that have recently been proposed.

The current-account position is not expected to improve much until 1992. This means that Canada will continue to depend on a large volume of foreign borrowing (Table 2-2). The Council's 25th Annual Review pointed out the dramatic changes in the sources of savings that occurred during the

Table 2-2

Sources and Uses of Savings, Canada, 1975-89[1]

	Private sector			Public sector			Net foreign savings[2]
	Savings	Investment	Net	Savings	Investment	Net	
	(Per cent)		(Percentage points)	(Per cent)		(Percentage points)	(Per cent)
1975	20.9	21.4	–0.5	1.2	3.7	–2.5	3.0
1976	21.2	21.7	–0.5	1.4	3.2	–1.8	2.3
1977	20.1	19.8	0.3	0.6	3.1	–2.5	2.2
1978	21.1	20.1	1.0	–0.2	3.0	–3.2	2.2
1979	22.3	22.2	0.1	0.7	2.7	–2.0	1.9
1980	22.9	20.7	2.2	–0.1	2.7	–2.8	0.6
1981	21.4	21.8	–0.4	1.1	2.6	–1.5	1.9
1982	22.4	16.1	6.3	–3.1	2.8	–5.9	–0.4
1983	23.0	15.6	7.4	–4.4	2.6	–7.0	–0.4
1984	23.9	17.6	6.3	–3.9	2.6	–6.5	–0.3
1985	23.6	17.5	6.1	–4.1	2.7	–6.8	0.7
1986	20.9	17.8	3.1	–2.9	2.5	–5.4	2.3
1987	20.5	18.6	1.8	–1.7	2.3	–4.0	2.2
1988	20.6	20.3	0.3	–0.6	2.3	–2.9	2.5
1989	20.7	20.8	–0.1	–1.0	2.4	–3.4	3.5

1 The data are expressed as proportions of GDP.
2 A positive number indicates an inflow of savings in Canada.
SOURCE Based on Statistics Canada, *National Income and Expenditure Accounts*, Cat. 13-001, various years.

period 1975-87.[4] Last year, Canada's net foreign borrowing was equivalent to 3.5 per cent of GDP – a new record for the period since 1975. In part, this can be explained by higher private investment in Canada, but the dependence on foreign savings also exists because of continued deficits recorded in the public sector. Ideally, at this stage of the business cycle, the public sector should be producing surpluses in order to finance its own investment and to avoid crowding out private investment or building up liabilities to foreign residents. Instead, the savings of foreigners are being used, in part, to maintain operating expenditures in the public sector. As a result, these borrowings (roughly 1 per cent of GDP) are not generating a future stream of earnings that will cover future interest payments.

In summary, the perspective offered in the base case has its encouraging side. A recession is avoided. The underlying rate of inflation is not expected to accelerate as a result of the introduction of the GST. The federal deficit will slowly recede, in both absolute and relative terms. Export growth will pick up; productivity will improve; and there is potential for growth in real wages. All of this is good news for Canadians. However, in this scenario, real interest rates are expected to remain high – much higher than they were in the early and mid-1970s; the Bank of Canada is not expected to meet its target of price stability; and the unemployment rate will not go below 7 per cent even in 1995, after four years of strong economic growth. Moreover, not much freedom evolves on the fiscal side to deal with environmental issues, infrastructure upgrading, or new directions and needs in the social policy area. Finally, Canada continues to build up its foreign indebtedness.

There are, of course, other possible futures to consider, as we shall now see.

Recession Risk

One of the possible risks of destabilization in the next year comes from a rise in world interest rates, which could result from German currency reunification or from an oil-price shock caused by continuing political instability in the Middle East. Given the strong demand situation that currently exists in Japan and Western Europe and given the integration of world financial markets, central bankers in Japan, the United States, and Canada would have little choice but to raise interest rates in order to forestall any new threat from international inflation.

Table 2-3

Alternatives to the Base Case, 1990-95

	1990	1991	1992	1993	1994	1995	Average, 1991-95
				(Per cent)			
Growth in:							
Real GDP							
Base case	1.6	1.3	4.0	3.4	3.2	3.1	3.0
Severe recession	1.4	–0.6	3.5	4.4	4.5	4.1	3.2
Inflation control	1.5	0.4	3.8	3.6	3.4	3.2	2.9
Budget interest rates	1.6	1.9	4.7	3.4	3.3	2.8	3.2
No fiscal restraint	2.0	1.5	3.9	3.3	3.1	3.1	3.0
Consumer price index							
Base case	4.7	6.0	4.3	4.3	4.0	4.0	4.5
Severe recession	4.7	5.8	3.8	3.6	3.2	2.9	3.9
Inflation control	4.7	5.8	3.8	3.6	3.0	2.6	3.8
Budget interest rates	4.7	6.2	4.7	5.1	5.1	5.4	5.3
No fiscal restraint	4.7	6.2	4.6	4.6	4.4	4.4	4.8
Unemployment rate							
Base case	7.7	8.2	7.9	7.8	7.8	7.7	7.9
Severe recession	7.7	8.7	8.9	8.7	8.2	7.6	8.4
Inflation control	7.7	8.4	8.3	8.2	8.2	8.0	8.2
Budget interest rates	7.7	7.9	7.4	7.3	7.2	7.2	7.4
No fiscal restraint	7.6	8.0	7.7	7.7	7.6	7.5	7.7
90-day Treasury Bill rate							
Base case	13.1	12.0	10.0	10.0	10.0	10.0	10.4
Severe recession	13.5	13.6	12.2	11.2	10.5	10.0	11.5
Inflation control	13.1	13.0	11.2	10.5	9.9	9.7	10.9
Budget interest rates	13.1	10.4	8.8	8.2	8.5	9.3	9.0
No fiscal restraint	13.1	12.4	10.5	10.6	10.6	10.6	10.9
As a proportion of GDP:							
Federal balance							
Base case	–3.4	–3.7	–2.9	–2.2	–1.6	–1.0	–2.3
Severe recession	–3.5	–4.6	–4.3	–3.5	–2.6	–1.7	–3.3
Inflation control	–3.4	–4.1	–3.6	–2.9	–2.3	–1.7	–2.9
Budget interest rates	–3.4	–3.3	–2.0	–1.1	–0.4	0.1	–1.3
No fiscal restraint	–4.7	–5.2	–4.6	–4.0	–3.6	–3.1	–4.1
Federal debt							
Base case	44.0	45.5	45.8	45.3	44.5	43.0	44.8
Severe recession	44.1	46.9	48.8	49.4	49.1	48.0	48.4
Inflation control	44.0	46.1	47.2	47.6	47.6	47.3	47.2
Budget interest rates	44.0	45.0	44.1	42.6	40.4	37.7	41.9
No fiscal restraint	44.4	47.2	48.8	49.7	50.2	50.1	49.2
Current account balance							
Base case	–2.7	–2.6	–2.1	–1.3	–1.0	–0.7	–1.5
Severe recession	–2.6	–2.1	–1.9	–1.2	–0.9	–0.7	–1.4
Inflation control	–2.6	–2.5	–2.0	–1.3	–1.1	–1.0	–1.6
Budget interest rates	–2.7	–2.9	–2.6	–1.9	–1.6	–1.2	–2.0
No fiscal restraint	–2.8	–2.9	–2.4	–1.6	–1.4	–1.1	–1.9

SOURCE Estimates by the Economic Council of Canada, August 1990.

In that event, Canada, already teetering on the brink of an economic downturn in 1990, could easily be tipped into a full-fledged recession in 1991, particularly if tight monetary policy were once again to widen the spread between U.S. and Canadian rates. Credit-sensitive sectors in Canada – durables, semi-durables, housing, machinery and equipment, and some commercial construction activity – would weaken further. Table 2-3 traces the impact of such an event. Real GDP would drop by half a percentage point in 1991, pushing the unemployment rate to almost 9 per cent in 1992. This weak labour market would help to contain any aftershock to the inflation that will follow the introduction of the goods and services tax, so that inflation would fall to the 3 per cent range by 1994, compared with 4 per cent in the base case (Chart 2-9).

At the same time, however, higher interest rates would lead to a rise in borrowing costs, while lower growth rates would result in a weakening of the tax base and higher unemployment rates would require increased transfer payments. These factors would propel the federal government's deficit (as a proportion of GDP) from 3.4 per cent in 1990 to 4.6 per cent in 1991. The ratio of government debt to GDP would also shift upward, as higher deficits would result in additions to the stock of debt. As a result, the government's fiscal plan would fall into disarray.

Lower Interest Rates

Another scenario is based on the assumption that deficit reduction will become the overriding objective for the next few years and that the fight against inflation will take second place among the government's priorities. To assess this option, we ran a simulation based on the interest-rate assumptions set out in the February 1990 budget – i.e., a drop in interest rates to 8 per cent by the fourth quarter of 1992 and in the exchange rate to 77.5 cents (US) by 1995.

The results, set out in Table 2-3, indicate that economic growth would be higher than in the base case. Under the circumstances, savings would be used to finance investment in the private sector, as opposed to excessive consumption in the public sector. The federal deficit would be eliminated by 1995; there would be a substantial drop in the debt-to-GDP ratio; and the ratio of business investment to GDP would rise by about half a percentage point. Each of these indicators would move in a direction that would strengthen future growth potential. The tradeoff for these gains is that inflation rates would average 5.3 per cent over the period 1991-95. If no change occurred in the patterns of wage and price decision making, it would also create a set of conditions that would provoke a new round of monetary restraint in the mid-1990s; this would lead to a roller-coaster pattern for growth and employment that would tend to offset the short-term gains from lower interest rates.

Inflation Control

The crucial question that arises in the inflation-control scenario is the degree to which the Bank of Canada can alter the patterns of wage and price decision making in a highly fragmented market system such as Canada's. This decision making is very costly to alter through the traditional approach of restricting credit and depressing the economy, even if the Bank of Canada's objectives were clearly stated. That is because wages and prices are set in response to a multitude of market signals; they also reflect the market power of the people striking the price or wage bargains. This puts the Bank of Canada in the position of using an instrument that has many side effects on employment, output, and the deficit before it achieves its stated goal. In this simulation, we are illustrating how the side effects would change if prices and wages were more flexible.

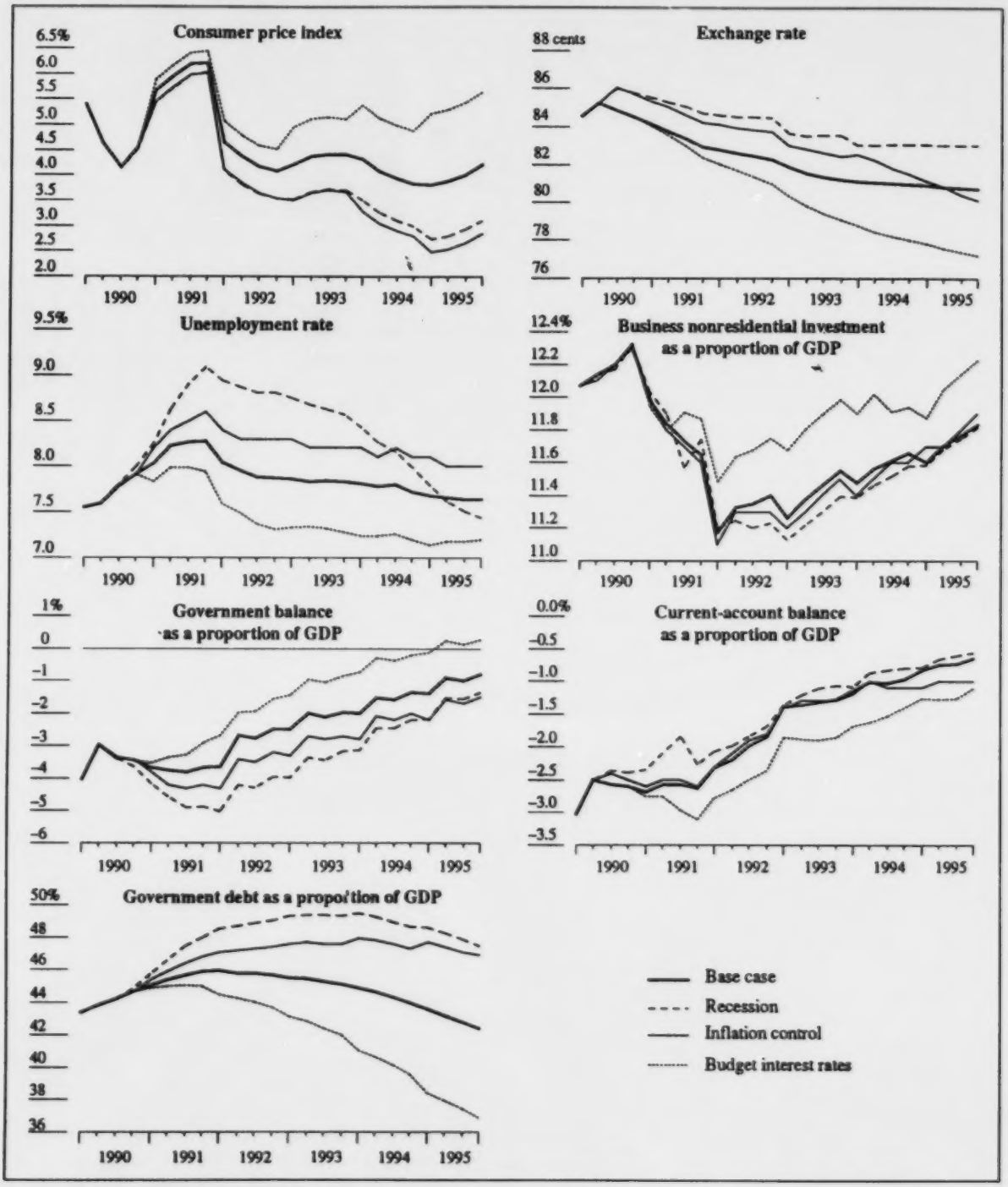
We have already seen that a spike in interest rates could cause a short, sharp recession, which would eventually lower inflation to the 3-per-cent range by 1994, but that the lag in the response time of prices and wages would make this an undesirable method for fighting inflation. In the inflation-control simulation, therefore, we show the impact of a change in the behaviour of economic agents – a change in which prices and wages respond more quickly to the explicit intentions of the central bank. In other words, we assume that inflation expectations would be forward-looking – anticipating some success in containing inflation. Thus the simulation consists of a sustained period of higher real interest rates – higher than in the base case, but not high enough to provoke a recession – plus the change in reaction time.[5]

Not surprisingly, the objective of 3-per-cent inflation can be achieved at a lower cost in this scenario than in the recession case examined above. The unemployment rate peaks at 8.4 per cent instead of 8.9 per cent, and the federal fiscal position slides to 4.1 per cent of GDP, rather than 4.6 per cent. Finally, although real rates of interest remain 1 percentage point higher than in the base case, nominal interest rates fall as the inflation premium that they encompass is reduced by about 1 percentage point.

The adjustments that we have made are rather arbitrary, but the reaction times are in the range normally anticipated by economists who count on changes in the expectations of economic agents to avoid severe damage from restrictive

Chart 2-9

Projected Impact of the Base Case and Three Alternative Scenarios on Selected Economic Indicators, Canada, 1990-95



SOURCE Estimates by the Economic Council of Canada.

policies. In the Council's view, however, the current approach to monetary policy is unlikely to bring about behavioural changes of this nature without the pain of a severe recession. We believe such changes can take place only if the key institutions that influence price and wage decisions are altered. We present our own ideas on this subject in Chapter 4.

Fiscal Restraint

The April 1989 and February 1990 budgets both contained a number of measures intended to reduce the federal deficit. The economic impact of that fiscal restraint is assessed by comparing the base case (which includes the two budgets) with the case labelled "No fiscal restraint" shown in Table 2-3. This case excludes the restraint measures but includes the GST, which has a direct impact on the rate of inflation.

The payoff from the fiscal restraint of the past two years shows up in two ways. First, the fiscal position of the government is improved. The stock of debt outstanding (the debt/GDP ratio) is reduced by about 7 percentage points by the mid-1990s. This, in turn, lowers debt-service costs by $10 billion by 1995.

The other payoff is in improved economic performance. As the policy mix shifts to rely more on fiscal restraint and less on monetary restraint, interest rates decline by about half a percentage point in 1991 (from what they would otherwise have been) and stay that much lower throughout the period to 1995. Over the longer run, this creates the foundation for higher investment, productivity, and incomes. In the first few years, however, output is slightly lower than in the absence of restraint, while the unemployment rate is slightly higher – 7.9 per cent with restraint, compared with 7.7 per cent without restraint.

What conclusions can we draw from this exercise?

First, the fiscal position is more robust than it was in early 1989. This progress has a positive effect on economic performance over the medium term, because it enables interest rates to decline. But that progress is limited. Even under the favourable economic conditions assumed in the base case, which includes relatively high interest rates, it still takes four to five years of strong economic growth to get the budget into a surplus position. And it is clear from the recession case described earlier that the budget remains vulnerable to recession and high interest rates. Thus the government has no choice but to continue to concentrate on deficit reduction over the next few years.

Second, the budget cuts of the past few years have added to the divisions in Canadian society, reawakening a sense of grievance in many provinces and many groups. While some further fiscal surgery is necessary, any drastic reduction in expenditures is likely to cut into programs – such as transfers to the provinces and to persons – in a way that would make consensus-building in Canada much more difficult. Such changes should not be made without a great deal of careful analytical work and consultation with the parties involved, including the population at large.

Third, the government will have to resist constant pressures to increase spending over the next few years in an attempt to achieve numerous social objectives, ranging from a cleaner environment to better public infrastructure. This means that a continuing round of reductions in current expenditure programs will be needed to find the funds needed to meet new priorities.

In short, the Council recognizes that further progress on federal deficit reduction will be difficult to achieve. We wish to underline, however, the need to build a better partnership between monetary and fiscal policies, and to consider new institutional arrangements that will permit better coordination of federal and provincial fiscal policies. The options for making such institutional changes are assessed in Chapter 4.

Performance Targets

In recent Annual Reviews, the Council has set out feasible performance targets for a five-year period. They are built on the expectation that Canadians will manage the economy in ways that will favour the well-being of both current and future generations. The targets established in the 26th Review are set out in Table 2-4, along with the projections contained in this year's base case, where the damage to the economy is controlled by a moderation in monetary policy, combined with a more favourable international environment. Even this scenario, which is the best that can be hoped for under current circumstances, produces results that fall well short of the desirable targets.

The situation is not entirely gloomy in the base case. Growth in productivity, employment, and output is close to the target ranges for the period 1992-95, when the economy returns to more normal growth rates. But

Table 2-4

Performance Targets and Projections

	Twenty-Sixth Annual Review targets	Base-case projections, 1992-95[1]
	(Per cent)	
Growth in:		
Productivity	1.5 to 2	1.3
Employment	1.5 to 2	2.0
Real GDP	3 to 4	3.4
Unemployment rate	5 to 7 by 1992	7.7[2]
Inflation rate	4 or less	4.2
Federal balance as a proportion of GDP	–1.5 or less by 1993	–2.2[3]
Net capital inflows as a proportion of GDP	–2 or less	–1.3
Social programs	Maintain objectives and substance of social programs; improve efficiency; and, where possible, fill the most urgent gaps	
Regional development	Balanced growth, employment opportunities, and social infrastructure	

1 The key financial assumptions in the base case for the period 1992-95 are as follows: real interest rates, 5.9 per cent; the Canada-U.S. interest rate spread, 2 per cent; and the average value of the Canadian dollar, 81.5 cents (US).
2 End of period.
3 1993.

performance will fall short of the Council's targets for the unemployment rate (which is projected to reach 7.7 per cent in 1995), for the rate of inflation (averaging 4.2 per cent over the period), and for the federal fiscal deficit (1 per cent of GDP in 1995).

What is unsettling, however, is that there is a serious possibility that even this relatively unsatisfactory performance cannot be achieved. Conditions in the world economy – rising interest rates and uncertain oil prices, plus the risk of a recession in the United States – raise the probability of a serious setback in economic growth. And when we attempt to sketch out policy options here in Canada, we encounter a logjam that cannot be broken without a change in expectations and attitudes. Any policy that has the potential to improve performance in one direction – lower rates of inflation, for example – causes an immediate deterioration in another key indicator, such as the unemployment rate or the deficit.

Conditions in the economy are simply not conducive to the full realization of the performance targets set out by the Council. This indicates that the usual technical solutions are unable to cope with the particular nexus of difficulties that Canada faces in the 1990s. New approaches are required; new institutional linkages must be forged. The Council believes that Canada must undertake to transform its economic policy framework in order to identify new ways to solve old problems.

The federal government will have no choice but to concentrate on deficit reduction during the next five years, while the Bank of Canada will have to focus on controlling inflation. Neither fiscal nor monetary policy can be effective in macroeconomic management if tightness systematically develops in labour markets long before imbalances – in the form of deficits, inflation, or unemployment – are corrected. This premature tightness in labour markets is associated with the wide variations in regional economic structure in Canada – a subject we examine in the next chapter.

3 Unemployment and Adjustment

Introduction

No country can escape the impact on its job structure of the transformation of the world economy, with new markets and new sources of competition emerging constantly. As we showed in Chapter 1, the shifting patterns of international trade prompted major changes in Canada's economic structure during the 1980s. These changes altered the employment profile of the Canadian labour market, with sharp declines in primary and some manufacturing industries and significant expansion in some service industries.

Sooner or later, shifts in the composition of exports and imports, in consumer preferences, and in production technology are reflected in the jobs available to Canadians. As a result of these changes, major layoffs occur in aging or noncompetitive industries, while new job opportunities are created in dynamic sectors that are attuned to the new international and domestic realities. The content of jobs changes to reflect new production processes, and wages rise and fall with shifts in labour demand and supply. In other words, the capacity for adjustment of an economy can be gauged by the operation of its labour market.

When labour markets are operating efficiently, workers can move from one job to another in response to their own preferences and to the changing needs of employers, without causing or experiencing costly disruptions. A properly functioning labour market thus enables structural change in the economy to proceed at a faster pace. It also facilitates economic growth and minimizes the hardships related to job change. By contrast, a labour market characterized by inflexibility, resistance to change, and institutional rigidities hampers growth and imposes real hardships on individuals and regions. High unemployment rates, long spells of joblessness, and pockets of chronic underemployment are all symptoms of an economy that is having trouble adjusting to new economic conditions.

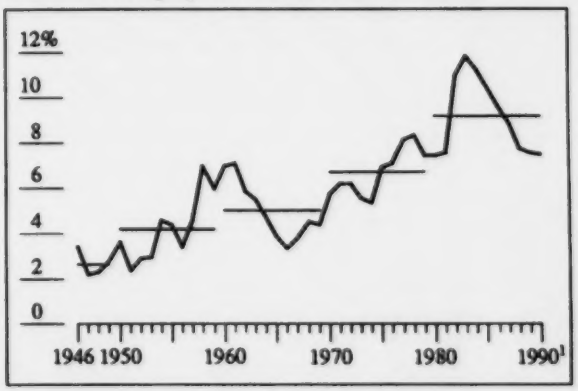
The persistent, secular rise in unemployment since the 1940s (Chart 3-1), despite strong job creation, suggests that Canada does not adjust effectively when market conditions change. The unemployment rate has risen from an average of 4 per cent in the 1950s to 6.7 per cent in the 1970s and 9.3 per cent in the 1980s (though it has averaged less than 8 per cent over the past two years). Thus the question now is whether the turbulence in global markets will lead to a further rise in the long-term average rate of unemployment or whether Canadians will be able to adapt to the new realities of the 1990s.

What has historically prevented Canadian governments from taking a more aggressive stance towards the problem of rising unemployment is the difficulty of achieving full employment while keeping inflation under control. As we have seen in Chapter 2, the Canadian economy is currently going through another period in which the federal government feels compelled to contain inflationary pressures by means of monetary restraint that, in the absence of changed expectations, will lead to higher unemployment.

In this chapter, after taking a closer look at the evidence about Canada's capacity to adjust – using the labour market as the benchmark – we seek to learn what lessons can be drawn from the experience of countries that have managed to keep unemployment rates low in the 1980s. What tools have they used to achieve high levels of employment while keeping inflation under control?

Chart 3-1

National Unemployment Rate, Canada, 1946-90



1 Average of seasonally adjusted data for January to June.
SOURCE Based on data from Statistics Canada.

Labour Market Rigidity

The Canadian economy currently exhibits a number of symptoms indicating that the process of adjustment is slow. In June 1990, over one million Canadians – 7.5 per cent of the labour force – were unable to find work. The lowest rate achieved in recent years was 7.2 per cent (in the first months of 1990), but this low rate was accompanied by inflationary pressures that had been evident for more than a year. Those who think that unemployment is not a serious problem do not realize that it is, in fact, a major source of collective impoverishment: for every worker who is unemployed, there is a direct price to pay in terms of forgone output and an indirect price in terms of higher social welfare costs and a weaker sense of social solidarity.

Regional Disparities

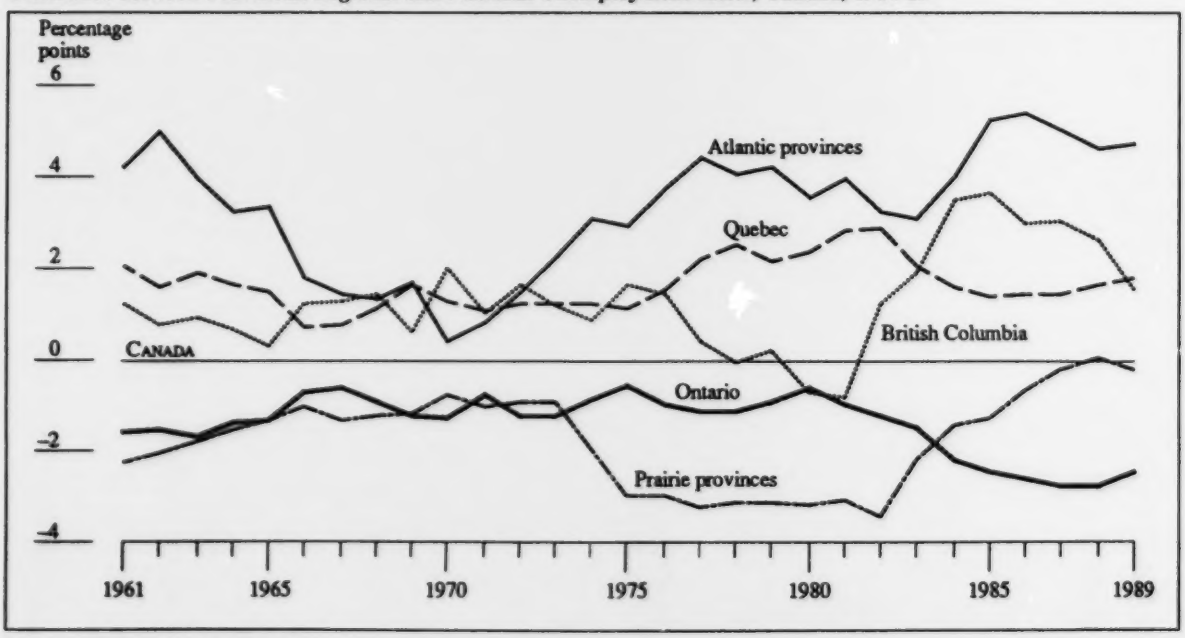
The signs of a failure to adjust smoothly are even more evident when seen from a regional perspective. There are large interregional differences in employment opportunities in Canada (Chart 3-2). Whereas in Ontario the unemployment rate averaged 5.5 per cent during the first half of 1990, in the rest of Canada it reached 8.8 per cent. Not only has there been a substantial difference between the highest and lowest regional rates (about 7 percentage points during the first half of 1990), but there has been no decline in these disparities over the past 15 years. Thus we are not facing a short-term difficulty, but a deep-seated, chronic problem.

Economic Structure

Each province in Canada has its unique economic structure – a particular mix of industrial and demographic characteristics. Part of the regional disparity in unemployment rates in Canada can be explained by structural differences – e.g., a concentration of highly seasonal industries or of people with low education in one province. But part of the disparity can also be explained by local market conditions and policy factors, such as the way in which incentives to work are influenced by regulations governing minimum wages, social assistance, and unemployment insurance. Work done by the Council during the past year throws new light on the importance of economic structure in explaining regional disparities in unemployment rates.[1] The work is also suggestive of the relative success with which provinces have adapted to change in the world economy. For example, structural unemployment declined in Quebec between 1981

Chart 3-2

Difference between Provincial/Regional and National Unemployment Rates, Canada, 1961-89



SOURCE Based on data from Statistics Canada.

and 1986, reflecting a period of economic renewal during the decade; over the same period, it increased in British Columbia, because the adjustment to the commodity price shocks and recessionary conditions of the early 1980s was still incomplete. The analysis only extends to 1986, because it is based on census data. Nonetheless, the story of the early 1980s provides useful insights into the capacity of provincial economies to adapt.

Chart 3-3 shows the degree to which the economic structure of individual provinces accounts for the disparity in their unemployment rates with respect to Ontario (data for Prince Edward Island are not available). Ontario has been used as the benchmark in this analysis because it is the largest province and because it was overheating in the Ontario economy in the late 1980s that provoked the shift to monetary restraint on the part of the Bank of Canada.

Quebec was in the throes of change in the 1970s. It faced a problem of declining industries – textiles, clothing, and oil refining, among others – as a result of changing world markets. It also experienced an exodus of head offices, plants, and people, as many English-speaking residents of the province were unable to accept the political objectives of the government elected in 1976. As the chart shows, the gap between Ontario and Quebec widened between 1971 and 1981, with economic structure accounting for about half of the differential in 1981. By 1986, however, only 33 per cent of the gap was explained by economic structure. The chart documents indirectly the economic renewal that took place in Quebec in the 1980s, as Quebeckers transformed old industries and created new businesses that were competitive in world markets. But the chart also highlights a relative deterioration in local market conditions and the influence of policy factors that kept unemployment rates higher than in Ontario.

Other provinces show less evidence of renewal in adapting to the structural changes of the 1980s. British Columbia was hit by a shake-out in commodity markets that forced mines and sawmills to close and led to the modernization of the pulp and paper industry. The chart shows that while there was virtually no gap in unemployment rates between British Columbia and Ontario in 1981, a substantial differential had developed by 1986, more than half of it accounted for by economic structure. This suggests that workers had still not adjusted to the modernization taking place in traditional industries and occupations of British Columbia.

In Saskatchewan, economic structure accounted for less than half of the unemployment rate disparity with Ontario in 1986. But we can speculate that the situation deteriorated even further during the second half of the 1980s, when that province (and, to a lesser extent, Alberta and Manitoba as well) was hit by a combination of drought, high interest rates, and falling world grain prices caused by a trade war between Europe and the United States. Farmers were particularly vulnerable to the slump, because they had accumulated $9 billion in long-term debt between 1973 and 1985 – a period when high prices created euphoric expectations about future incomes. Many of those indebted farmers might have been able to cope if interest rates had remained at the levels typical of the late 1970s and even the mid-1980s. But when monetary policy tightened in 1988 in response to inflationary pressures in central Canada, the surge in interest costs put otherwise viable farms at risk, and the rise in the value of the Canadian dollar reduced the returns to Canadian producers.

The debacle in farm incomes caused far more hardship than existing insurance and stabilization schemes could handle. As a result, the federal government made a number of special payments to grain farmers to help them bridge the period of low prices and high interest rates. In 1987, according to the Council's in-depth analysis of the Prairie grain economy, federal support amounted to $36,000 per farm in Saskatchewan; further special payments have been made since then. Last year, it is estimated that this support averaged up to $31,000 per farm.[2]

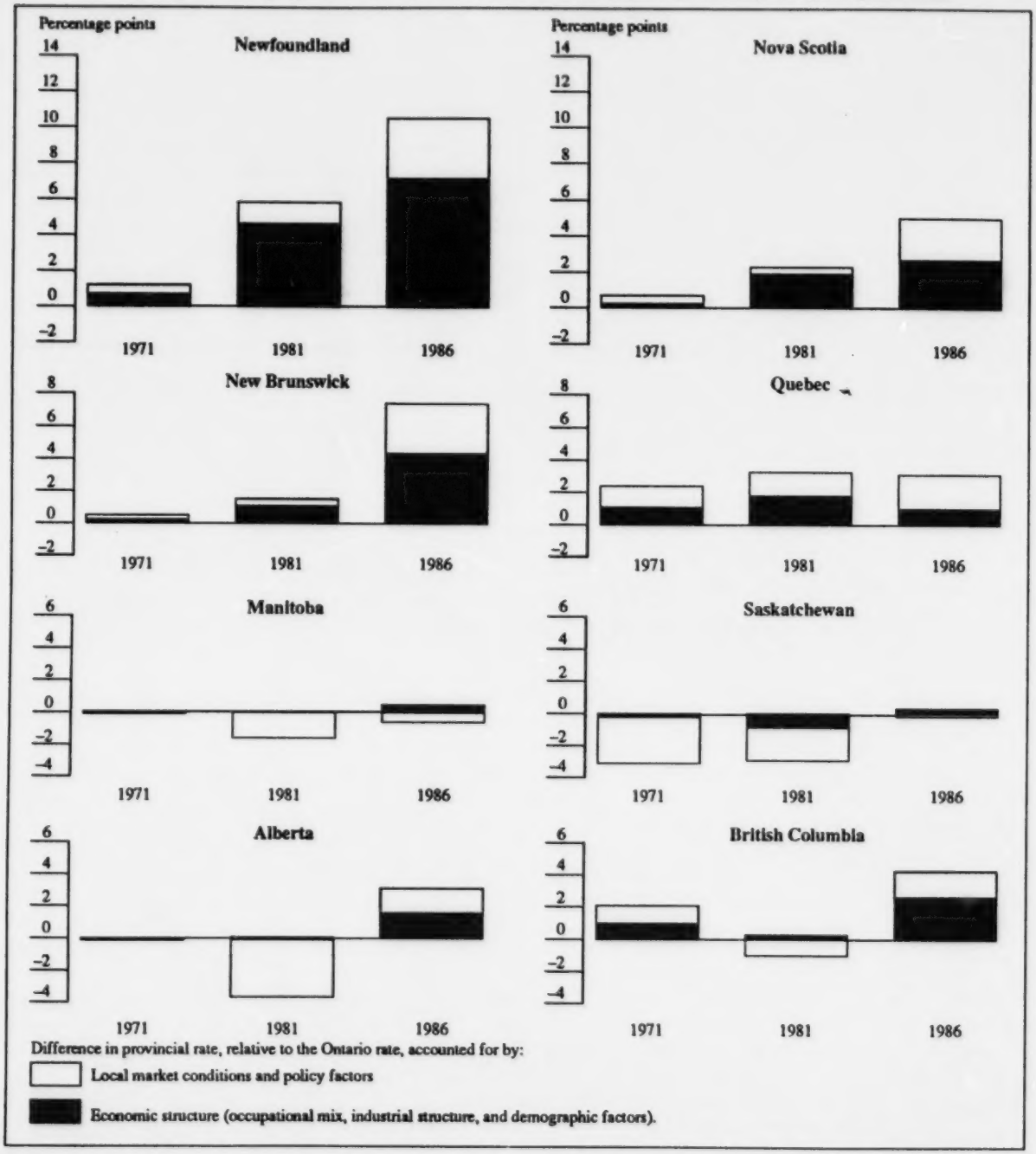
In its report, *Handling the Risks*, the Council pointed out that special support programs are likely to be counterproductive over the medium term. If they are based, for example, on acreage seeded or the production of certain crops, they signal to Prairie farmers "that they should persevere in producing traditional export grains rather than diversify their crops, set up a livestock operation, or quit farming."[3] In short, such programs inhibit adjustment to market realities.

In Newfoundland, economic structure accounted for about two-thirds of the gap in unemployment rates vis-à-vis Ontario in 1986; there had been a notable widening of the gap between the two provinces after 1971: it grew from 1 to 10 percentage points over the period. The industrial and occupational mix and the education and age structure of the work force accounted for most of this deterioration.

More recently, the decline in North Atlantic cod stocks has devastated the fishery in Newfoundland (and, to some extent, in Nova Scotia as well). The federal adjustment package, valued at close to $600 million over five years, is being used in large part to improve the way the resource base is being managed. Meanwhile, the communities eligible for funds wish to use the money to meet their one overriding objective – to reopen the local fish plant.

Chart 3-3

Provincial Disparity in Unemployment Rates Relative to the Rate for Ontario,[1] Canada, 1971, 1981, and 1986



1 For each province, the height of the bar shows the difference between the unemployment rate of that province and the Ontario rate. See Appendix E for a summary of the methodology used in deriving the estimates.

SOURCE Andrew Burns, "Unemployment disparity: An analysis of the role of economic structure," Working paper (forthcoming), Economic Council of Canada.

But these plants will only be viable commercially if the fish stocks are replenished; and the stocks can only be rebuilt if the allowable catch is curtailed for a sustained period. Even then, it seems unlikely that the fishery will ever be able to generate enough revenue to provide adequate income for everyone who wants to work in the sector. The federal government has set the allowable catch for 1990 at levels higher than those recommended by scientists and by an independent study group.[4] This is likely to slow down the rebuilding of the stocks and, at the same time, to inhibit the communities affected from facing up to the need to establish a new economic base to replace or buttress the fishery. The net outcome may leave many Newfoundlanders unemployed and dependent on income support programs in the 1990s.

The examples of Saskatchewan and Newfoundland show that sectoral policies are often at odds with the national objective of identifying opportunities for new types of production and employment. Other examples of well-intended government programs that were ineffective in promoting adjustment in the shipbuilding, textiles, and pulp and paper industries were documented in another Council Statement.[5]

Sectoral policies that attempt to preserve a way of life risk inhibiting adjustment. This does not mean that the Council opposes policies that help to spread risks when an industry or a region faces hard times. Rather, we believe that adjustment programs should be designed to help people make decisions that will lead to the diversification of risk or to relocation to an industry or a community where jobs are available. In this context, we note that a task force mandated by the federal Minister of Agriculture (with the support of his provincial colleagues) to improve the safety nets for Canadian farmers recently made recommendations for income stabilization that are somewhat similar to those put forward by the Council in *Handling the Risks*.

There is no question that the marked differences in economic structure between the regions of Canada make the country more difficult to govern. Policies that are national in scope, like monetary restraint, can have devastating effects on particular sectors or regions, thus aggravating the dimensions of the adjustment problem. At the same time, policies that are provincial or sectoral in scope can impede adjustment; if they are too preoccupied with "preserving a way of life," they create dependency and an ongoing drain on transfer payments.

Mismatching

In a context where an industry is in decline and its employment is shrinking, an efficient labour market should ensure that the workers affected move to another job in the same firm, in another firm, or in another industry. This obviously does not happen as quickly or as smoothly as one would like, since individuals have unique skills and there are sometimes wide distances between employers in a country as large as Canada. Thus when the economy is in the throes of fundamental change, it would be natural to anticipate that some individuals would have difficulty making the transition. A number of the Council's studies and reports have pointed to this mismatch between people and jobs as one of the reasons why Canada is experiencing high rates of unemployment.[6]

In analysing a Statistics Canada survey in which a sample of workers are asked about their employment and unemployment experience over a period of 12 months, Council researchers found that the majority of workers do make a successful transition with little or no time spent unemployed. Of all the successful job finders interviewed in 1986, for example, about one third moved directly from one job to another, with no time spent unemployed; another 30 per cent found a job within four weeks of leaving the previous one. In total, 64 per cent of the people who found new jobs in 1986 did so with minimal disruption to employment. These successful job changers were most often people who:

- had quit their jobs voluntarily (i.e., no layoff was involved);
- lived in Ontario (with Quebec a close second);
- were males, aged between 25 and 44; and
- changed jobs within the same industry.

Conversely, the least successful job changers were most often those who:

- had lost their jobs due to an involuntary layoff;
- lived in western Canada or the Atlantic provinces;
- were over 45 years of age;
- were women; and
- changed to a new industry or a new sector.

Other studies have shown that the greatest degree of hardship – being unemployed for more than half a year – is concentrated in a relatively small group of people who account for 6 per cent of the labour force.[7] These people

accounted for 29 per cent of all unemployed individuals in 1986 and for 60 per cent of all the time spent unemployed during that year.

Thus, from a policy point of view, there is evidence that labour markets in parts of the country where there is a diversified economic structure function quite efficiently, although there may be special problems among older workers and for workers hit by layoffs. In *Good Jobs, Bad Jobs*, the Council made a number of recommendations aimed at easing the transition for these workers, including advance notice of layoffs (with the length of the notice period varying according to the magnitude of the layoff), the requirement that labour-management adjustment committees be established, and more investment in training.

The dysfunction in the labour market appears to be most severe in rural, resource-based regions, where the limited range of job opportunities makes it far more difficult to match the skills of the unemployed with the needs of employers. In fact, the mismatch problem is very closely linked to the problem of economic structure and to the underlying difficulties that some Canadians experience in adapting to new market opportunities or their reluctance to migrate to places where jobs are more readily available.

Persistence of Unemployment

Another symptom that the economy is adjusting slowly is the persistence of unemployment in the face of external shocks (i.e., the slowness with which it returns to its previous level), which has never been more evident than in the 1980s. The only other time this phenomenon appeared so strongly was during the recession of 1958. In both 1958 and 1982, the unemployment rate rose by about 4 percentage points, and it took over six years of sustained economic growth before the rate returned to pre-recession levels. Analysis done at the Council indicates that the persistence of unemployment throughout the 1980s is largely associated with the fact that unemployed workers take longer to find a new job than used to be the case.

The unemployment rate that is quoted in the newspapers is a snapshot, taken once a month, that simply reflects the situation on the labour market at the moment the shutter clicks. In the course of a year, the total number of people affected by unemployment is much greater than the monthly rate might suggest. For example, the unemployment rate averaged 9.5 per cent in 1986, but fully 20.6 per cent of the labour force experienced at least some unemployment during that year. The reason for the difference between the two percentages is, of course, that most spells of unemployment are quite short (less than three months).

During the period 1978-80, about 22 per cent of the labour force experienced some unemployment in any given year. In 1982, this proportion shot up to 28 per cent; it remained high until 1986, when it finally fell back to the 20-per-cent range. Although the percentage of the labour force experiencing some unemployment during a given year did return to its pre-recession level, the average amount of time spent unemployed during the year did not. Chart 3-4 divides the rise in unemployment since 1980 into the portion due to increased incidence and that due to increased duration. Looking first at Canada as a whole, the chart shows that, as the economy recovered, the incidence of unemployment fell, eventually returning to its pre-recession level in 1988. Duration, on the other hand, has remained an important factor, and it accounts for most of the persistence of high unemployment rates during the post-recession period.

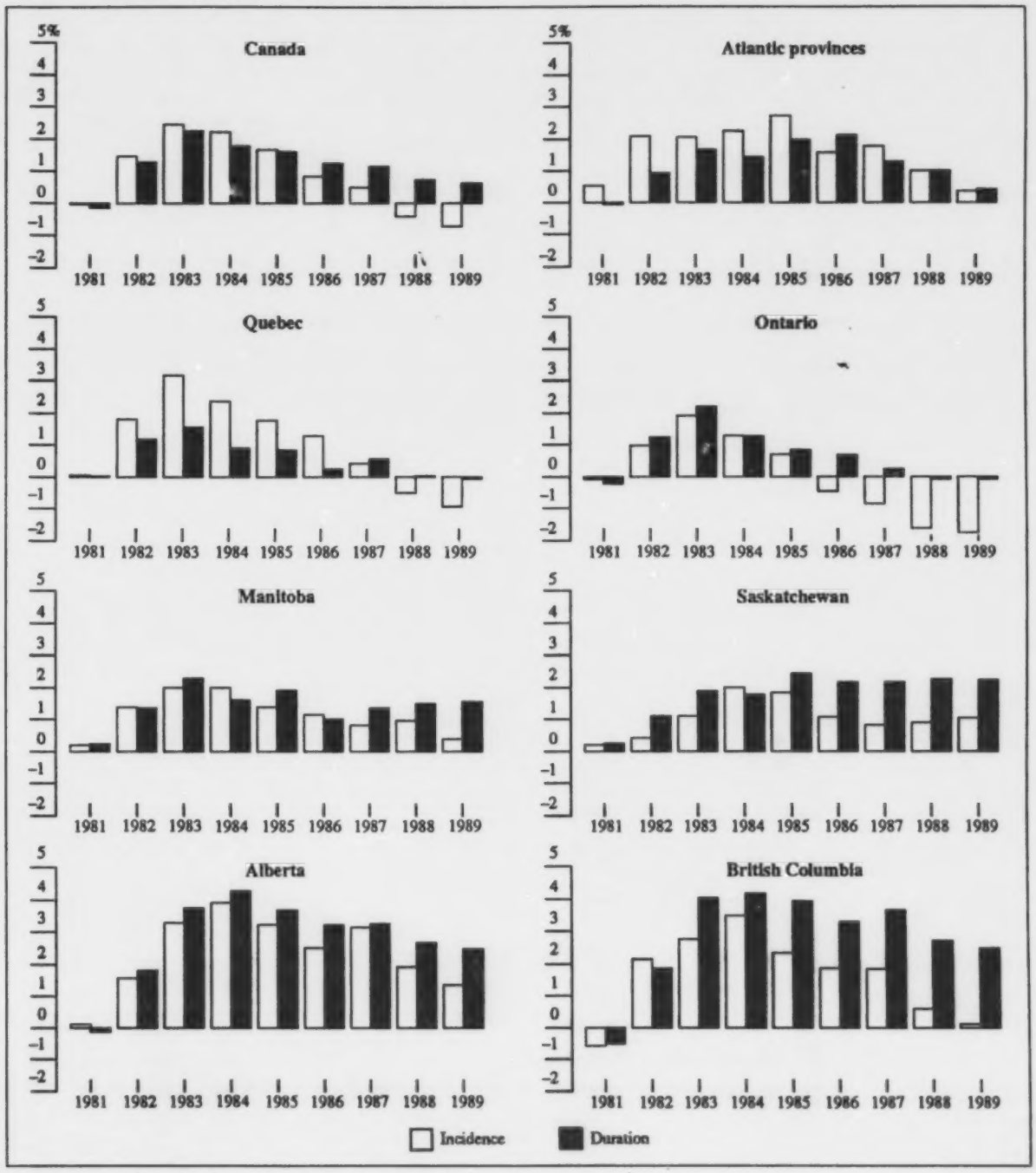
The story is even more revealing at the regional level, as Chart 3-4 also shows. All provinces experienced a radical jump in the incidence and duration of unemployment during the recession of 1981-82. As the recovery took hold, however, distinct regional patterns emerged. As a general rule, the incidence of unemployment began to decline after remaining high for a year or two. By the end of 1989, the impact of increased frequency on regional unemployment rates had fallen dramatically – to zero or negative values in Ontario and Quebec. At the same time, however, in all provinces where unemployment in 1989 remained higher than in 1980 – the Atlantic provinces and the four western provinces – the influence of duration remained strongly positive. Provincial unemployment rates did not fall, or fell only slowly because the duration of unemployment spells lengthened, especially in the western provinces.

The persistence of unemployment rates, marked regional disparities, and a steady, long-term rise in the rate of joblessness are the outward signs that certain regions or groups are not adapting well to the new economic realities. The worrisome thought is that the current focus of economic policy on the control of inflationary pressures may well help to aggravate the rigidities discussed above. In the absence of other supporting economic tools to control inflation, this means that government authorities must use greater force (i.e., even higher interest rates and a higher value for the Canadian dollar) to achieve their objective of wage and price moderation.

High interest rates add to those stresses in a high-unemployment region. Such pressures are particularly painful for small businesses, which have limited means to diffuse their impact. The overvalued dollar affects the competitiveness of industries that rely heavily on resource exports, particularly those whose prices are set in U.S.

Chart 3-4

Contribution of the Incidence and Duration of Unemployment to National and Provincial/Regional Unemployment,[1] Canada, 1981-89



1 Expressed as a change in the unemployment rate from its 1980 level.

SOURCE Estimates by the Economic Council of Canada, based on data from Statistics Canada.

dollars on world markets. The end result is that periodic attempts to control inflation in the short run tend to inhibit the restructuring that is needed for the long-term health of the regions. Not only do they reduce the capacity of existing firms to modernize, but they also discourage the formation of new firms that would offer new job opportunities in the region. Clearly, Canadians need to find a means of fighting inflation that is compatible with improving the adjustment capacity of their economy.

Remedies

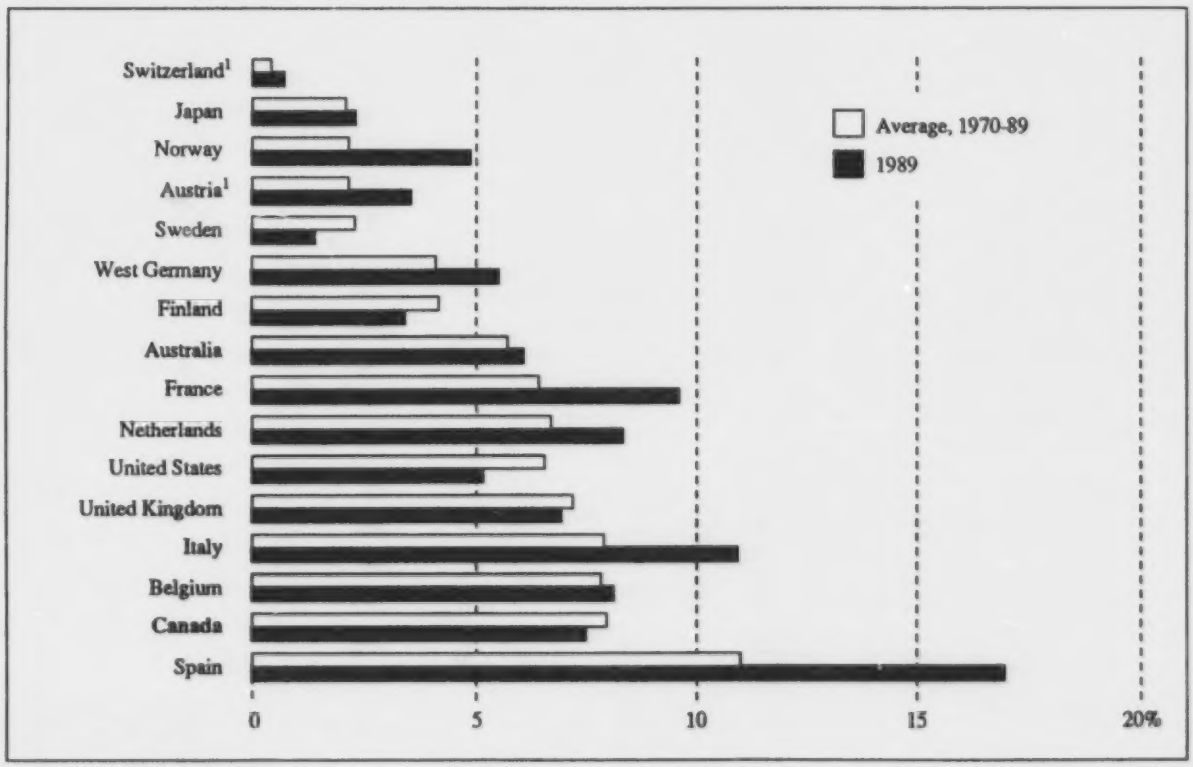
One might be tempted to infer from the Canadian experience in the 1980s that only a severe recession and a long period of restrictive monetary policy will serve to reduce or control inflation, even though such a remedy has strong adverse effects on the labour market and on regional economies. Yet certain countries – Austria, Sweden, Norway, and Japan, in particular – have managed for more than 20 years to contain inflation without creating unemployment. These countries appear to have been able to make the necessary adjustment and adaptation, and to record overall good economic performance without causing major dislocations in labour markets. Thus it may be possible to draw some lessons from a comparison of the approaches of these countries to the quest for full employment with the Canadian experience, in an effort to see whether or not the Canadian strategy towards the fight against inflation and unemployment could be improved.

Some Foreign Experiences

Chart 3-5 shows the unemployment performance of the major OECD countries over the period 1970-89. Among the 16 countries for which the OECD publishes standardized unemployment rates, Norway, Sweden, and Japan stand out, with rates that remained consistently below 4 per cent over most of the period.[8] Prior to the 1981-82 recession, West

Chart 3-5

Standardized Unemployment Rate, Selected Developed Countries, 1970-89



1 Nonstandardized rates are used.

SOURCE Organisation for Economic Co-operation and Development, *OECD Economic Outlook* (Paris, June 1990).

Germany also had a remarkable performance on the unemployment front, but it has since joined the ranks of the high-unemployment countries. While standardized unemployment rates are not available for Switzerland and Austria for the entire period, these two countries also displayed a consistent record of low unemployment rates.

Those countries managed to achieve low unemployment rates without sacrificing other economic objectives, such as economic growth, price stability, or financial soundness. They performed no less well than Canada on all those scores; indeed, Norway had a much better performance than Canada in terms of economic growth, thanks in part to the development of its oil reserves (Chart 3-6). The record in Austria, Japan, and West Germany (in the period 1973-79) was roughly comparable with that of Canada.

The same is true with respect to the fight against inflation (Chart 3-7). While the experience of Norway and Sweden has been similar to Canada's, Austria, Switzerland, and West Germany have clearly outperformed Canada since 1973. Because Japan was so severely affected by the first oil price shock in 1973, its inflation rate surged above Canada's during the period 1973-79, but since that time Japan has posted the lowest inflation rates of the countries under review.

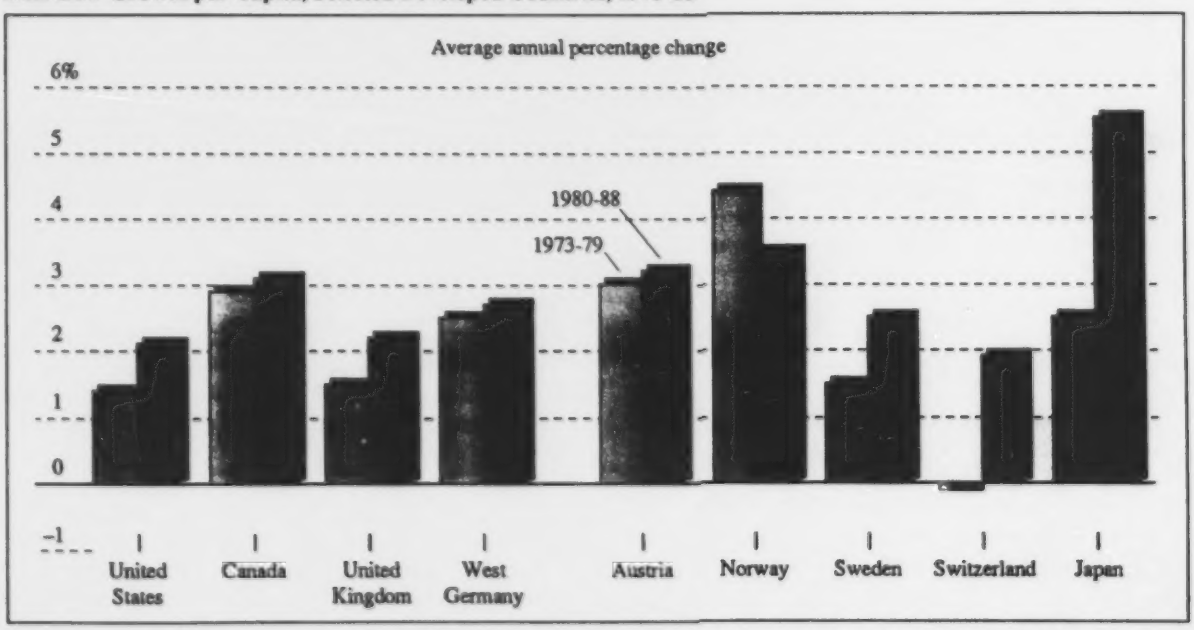
Neither has the pursuit of full employment meant that the budgetary situation in those countries had to be jeopardized. On the contrary, each of them has made it a point to wisely manage its public finances. In 1989, none of the countries recorded a larger budgetary deficit than Canada, as a proportion of GDP. In terms of accumulated debt, Canada came close to dead last, whereas Sweden was basically in balance, and Norway enjoyed an accumulated surplus, thanks to its rich endowment in petroleum resources.

These countries have been exposed to the same external pressures from a rapidly changing world economy and to the same shocks from international economic conditions as Canada. And apart from Japan, all of them appear to be more open than Canada, judging from the ratio of their imports and exports to domestic output.

True, Canada's population is relatively young, compared with that of many European countries, and it has experienced rapid labour-force growth in the last two decades. These labour supply developments have forced Canada to work harder in terms of job creation. In Canada's case, unfortunately, it does not appear that even strong employment growth has been sufficient to bring the unemployment rate down to the levels recorded by full-employment countries.

Chart 3-6

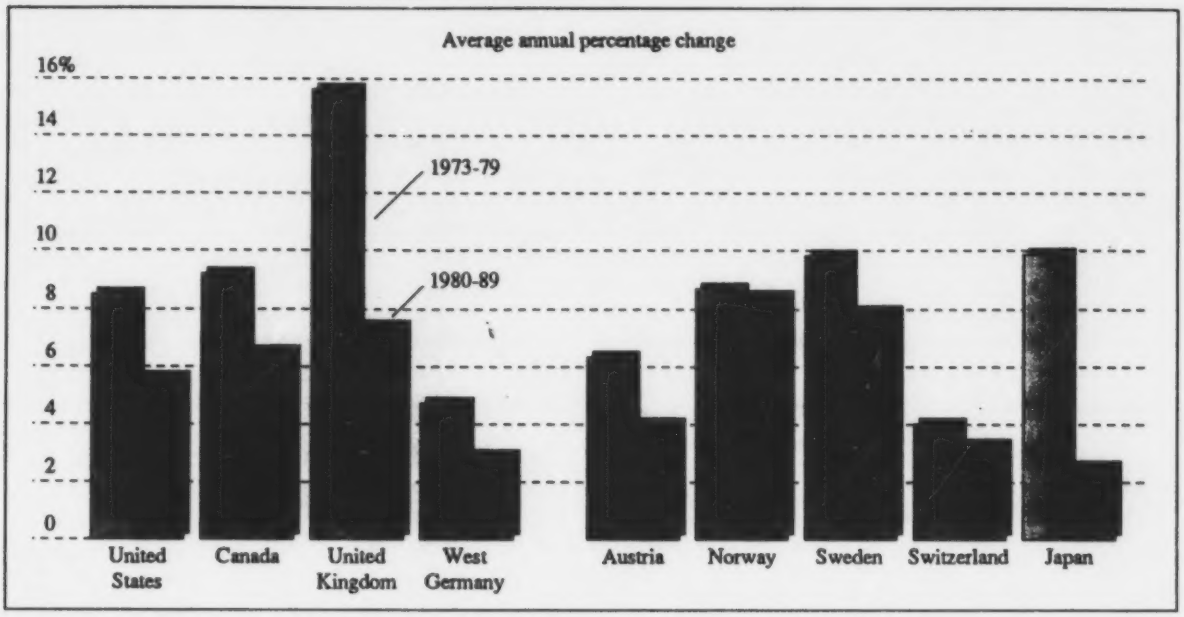
Real GDP Growth per Capita, Selected Developed Countries, 1973-88



SOURCE Organisation for Economic Co-operation and Development, *OECD Economic Outlook: Historical Statistics, 1960-1988* (Paris, 1990).

Chart 3-7

Consumer Price Index, Selected Developed Countries, 1973-89



SOURCE OECD, *OECD Economic Outlook* (June 1990), and *OECD Economic Outlook: Historical Statistics, 1960-1988.*

Towards Full Employment

A number of studies have investigated models of full employment in the hope of drawing some firm conclusions.[9] On the basis of the main characteristics and policies of countries enjoying low levels of unemployment, however, it is clear that there are no simple solutions or magic formulas for achieving full employment. Each country finds its own solutions in accordance with its particular institutional, historical, and cultural context. Each has developed institutions and procedures to address the problem of unemployment in an efficient manner. In addition, these institutions and procedures have evolved over time, a clear indication that there is no simple and immutable model or formula.

The uniqueness of the Austrian approach, for example, lies in its sophisticated social-partnership system, coupled with an exchange rate policy that ties the schilling to the deutschemark in order to contain the prices of imported goods used by Austrian companies and to enhance their competitiveness. This policy contrasts with the frequent use of currency devaluation by Sweden as a means of boosting exports. Whereas Austria and Norway have based their strategies largely on cooperation and discretionary macroeconomic policy without worrying unduly about labour market policy, the reverse is true in Sweden and West Germany, whose strategies are based above all on well-developed labour-market policies.

Despite these differences, it is possible to identify a number of common features of these foreign models that may help to explain their success in facilitating labour market adjustment and achieving full employment.

A National Commitment

The countries that have achieved full employment have made it their primary policy objective (see box). This is true not only of their governments but also of the other social partners involved – labour and business. This commitment shapes the attitudes, actions, and behaviour of all the partners.

For governments, employment becomes a prime consideration when decisions are made regarding new economic or legislative initiatives. For labour unions and employers, the priority on employment necessitates some changes in behaviour. For example, they must take into account the

What Is Full Employment?

What exactly is meant by full employment? At the risk of oversimplifying, one can distinguish two basic approaches to the concept. The first, which might be called "institutional," describes the concept as it has been applied in the adoption of full-employment strategies by certain European countries. Diane Bellemare and Lise Poulin-Simon have proposed the following definition in *Le défi du plein emploi*:

> In a democratic society that seeks to improve standards of living, full employment refers to a situation in which every person who wants to work – at the prevailing wage rate, in a job for which he or she is trained, and in a job located close to his or her place of residence – has the opportunity to do so.[1]

Generally speaking, therefore, championing full employment amounts to calling for measures to eliminate involuntary unemployment.

As Bellemare and Poulin-Simon also point out, however, a precise statistical definition of full employment presents a number of difficulties. For example, the unemployment rate does not take into account the labour market participation rate. The government could theoretically reduce the rate of unemployment by introducing measures to induce large numbers of workers to withdraw from the labour market (e.g., high tax rates on employment earnings). But could this truly be considered full employment? On the other hand, the full-employment objective might include the goal of removing the barriers that prevent certain people not in the labour force from actively looking for work (e.g., availability of adequate daycare services and deductibility of daycare costs, better fringe benefits for part-time employment, and so on).

In a situation of full employment, unemployment figures would normally reflect only the situation of those people who are frictionally unemployed, the rate then being about 2 or 3 per cent. The Canada Employment and Immigration Advisory Council recently recommended that "four per cent unemployment continue to be construed as a state of 'full employment' in Canada."[2]

The other definition corresponds to a "technical" conception of full employment and is the fruit of developments in economics over the past few decades; it serves as the basis for the current stance of economic policy in countries such as Canada, the United States, and Great Britain. Full employment is defined in terms of what governments can do, in the short term, to eliminate unemployment without sparking a new round of inflation. Thus whatever unemployment cannot be attributed to insufficient aggregate demand is the level of unemployment under full employment.

In the 1980s, full employment was thus identified by many economists with the natural unemployment rate or the non-accelerating inflation rate of unemployment (NAIRU). The most recent estimates place the NAIRU between 7.6 per cent[3] and 8.0 per cent.[4] The present situation in Canada in 1990, therefore, can be viewed more or less as a situation of full employment, according to the "technical" definition of full employment.

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1 "Dans une société démocratique qui vise une amélioration des niveaux de vie, le plein emploi désigne une situation réalisée lorsque toute personne qui veut travailler au taux de salaire courant, dans un travail pour lequel elle a été formée et à proximité de son lieu de résidence, a la possibilité de le faire." Bellemare and Poulin-Simon, *Le défi du plein emploi*, p. 330.

2 Canada Employment and Immigration Advisory Council, *Full Employment Is an Achievable Goal* (Ottawa: Employment and Immigration Canada, April 1990), p. 3.

3 See Andrew Burns, "The natural rate of unemployment: A regionally disaggregated approach," Working paper no. 2, Economic Council of Canada, Ottawa, 1990.

4 See David E. Rose, "The NAIRU in Canada: Concepts, determinants and estimates," Technical report no. 50, Bank of Canada, Ottawa, 1990.

repercussions on employment of their actions in favour of price and wage increases.

It is not enough for the various economic groups to make full employment a priority and to modify their behaviour accordingly; there must also exist an institutional framework for developing and implementing a full-employment strategy. Countries with success in this regard have established significant control over one or more strategic economic levers – over macroeconomic policy, over the mechanisms for labour-supply and labour-demand adjustment, over wages and prices through an incomes policy, and so on. In other words, the

pursuit of full employment requires not only political will, but also an institutional infrastructure.

Participation

One of the basic traits these experiences have in common is the search for consensus among the social partners to support economic management and the full-employment strategy. Different forms of partnership linking government, management, and labour have been tried during the postwar period. The labour movement and the business community have worked in conjunction with governments to define policies jointly and to choose specific programs. In certain cases (Austria and Norway, for example), the private-sector partners have wielded genuine decision-making power over the direction of economic policy.

The involvement of the social partners is even more decisive in the orientation and administration of labour market policy, where decisions are made more or less independently of the governments in power. West Germany provides a striking example: when the labour unions withdrew from "Concerted Action," a national tripartite committee aimed at fostering cooperation on macroeconomic policy, the government retreated from its full-employment commitment.

For this cooperative process to work, both workers and employers must obviously be organized in associations. In all the countries involved in this discussion, labour and management organizations are highly structured and heavily centralized, and they are able to speak with authority on behalf of their members. A certain spirit of cooperation must also exist – a minimum degree of consensus on basic goals and on the nature of current economic conditions and problems.

Tripartite Management

In Sweden, West Germany, and Norway, labour market policies operate according to tripartism (cooperation between government, labour, and business) and regionalism (decentralized decisions). Because it allows programs and policies to be developed on the basis of up-to-date and accurate information, regionalization offers solutions for the employment problems of particular groups and for chronic unemployment in particular regions. A high degree of independence from the government also helps to eliminate long lead times and to make initiatives more tightly focused.

Tripartite management also has the advantage of letting responsibility devolve upon local groups and actors, thereby improving efficiency. In addition, both unions and management gain professional expertise in labour market policy when they are jointly involved in its development and administration.

The Fight against Inflation

In their fight against inflation, the countries examined here were not prepared to put jobs at risk. Rather, they coupled their (usually expansionist) macroeconomic policy with other policies designed to contain inflationary pressures, such as exchange-rate depreciation, negotiated incomes policies, and increased wage flexibility in exchange for long-term employment guarantees (even lifetime guarantees, in the case of Japan). When restrictive fiscal or monetary policies have been introduced, they have been accompanied by selective interventions and active labour-market measures to cushion their impact (Sweden) or by institutionalized labour hoarding (Japan).

The use of incomes policies is widespread, but governments in these countries have eschewed wage controls. Rather, they seek to determine wage increases through a two-pronged negotiating process, in which centralized bargaining plays an important and very visible role. Generally speaking, the cooperation of unions and workers in the fight against inflation is secured in exchange for assurances that other measures will be directed towards the goal of full employment.

Centralized wage negotiations play a significant role in the fight against inflation. One study views it as an institution that has greatly favoured the development of a "socially responsible" attitude within the labour movement, as the demands of workers are based on their own assessment and understanding of the effects of wage settlements on price levels and general economic health.[10]

Synchronized negotiations would also appear to have been a major weapon in the fight against inflation. This system avoids wage-to-wage leapfrogging, whereby a high wage settlement in one major contract becomes the basis, at a later date, for a still larger settlement elsewhere in the economy.

The Influence of Labour

In all the countries under discussion, the labour movement wields considerable influence, not only because of high unionization rates (except in Japan and Switzerland) but also because most of those countries have long been governed by left-of-centre governments. Because of the

labour movement's natural affinity with social-democratic governments, it has been successful in placing the full-employment goal near the top of the list of government priorities during the postwar period. While governments have come and gone, the full-employment strategy has endured so long as it has been the focus of a national consensus and so long as the labour movement continued to be actively involved in defining economic policy. This last condition seems essential; as we have seen, the end of the national participatory scheme in West Germany also marked the demise of the full-employment objective.

The Canadian Model

Canada has never made more than a timid commitment to full employment. In recent years, inflation and the government deficit have taken turns at being the chief priority of policy in Canada, and those two problems rank higher than unemployment at the present time.

A Historical Commitment[11]

This country's strongest commitment to full employment came with the publication of the White Paper on Employment and Income in 1945, which laid out the economic strategy of the federal government for the postwar era.[12] A political consensus had emerged that democratic governments had a duty to act to maintain the degree of economic stability and full employment that had developed during the war years.

Still, even in those heady times there was reluctance to speak of full employment; the preferred expression was "high levels" of employment. Although the original draft of the White Paper had specified that the government's goal was to be "full employment," the minister responsible for reconstruction, C. D. Howe, insisted that the phrase be changed, fearing that it would force the government to guarantee something that might be beyond its power to provide. The phrase that was adopted – "a *high* and *stable* level of employment and incomes as a major aim of employment policy" – clearly illustrates the limited nature of the commitment being made.[13]

The best indication of the choices being made at the time by Canadian society was the overall Keynesian orientation of economic policy that underlay that commitment. Because Keynesianism regarded unemployment as the result of insufficient aggregate demand, the task of government was viewed as ensuring that the various components of aggregate demand remained stable, and thus as maintaining high levels of employment. Government did not have to worry about shaping supply conditions through programs aimed at investment, technology, or the labour market, as these factors were deemed to be the purview of market forces.

Thus the approach that emerged was pragmatic, apolitical, and technocratic, and it had little impact on Canada's institutions and political practices. There was no need for planning boards or regulatory bodies. Since economic management was to be carried out by experts, there would be no need for popular participation in decision making or for the implementation of consensus-building machinery.

During the 1950s and 1960s, with the simultaneous appearance of inflation and unemployment, governments began to make increasing use of monetary and fiscal policy in the fight against inflation. While there was no official abandonment of the "high employment" goal, it was clear that it had to give way – at least to some extent – to the control of inflation.

The year 1975 can be seen as a watershed in the government's approach to unemployment. The fight against inflation became the overriding objective on the political agenda. The rise of monetarism, the imposition of ceilings on government expenditure growth rates, an increasingly market-oriented approach to economic policy – all of these factors signalled that higher levels of unemployment were becoming politically more acceptable than in the past. The "high and stable employment" objective had clearly lost some of its political and moral resonance, and faith in Keynesian stabilization policies had severely diminished. The oil price shocks of the 1970s had precipitated a reordering of economic management objectives.

In the early 1980s, the government's efforts to end the inflationary spiral led to the adoption of monetary policy so restrictive that the only possible outcome was a recession. The bank rate had risen to 21.2 per cent by the summer of 1981. The rest of the story is well known: unemployment rose by 4 percentage points within a few months, and the rate of inflation decelerated from 12.5 per cent in 1981 to 5.8 per cent in 1983.

The Current Approach

At the moment, the battle against unemployment is borne solely by policies targeted at the labour market. Those policies have tended to favour income-support programs, which are designed not to eliminate unemployment but to lighten the burden on those it touches directly.

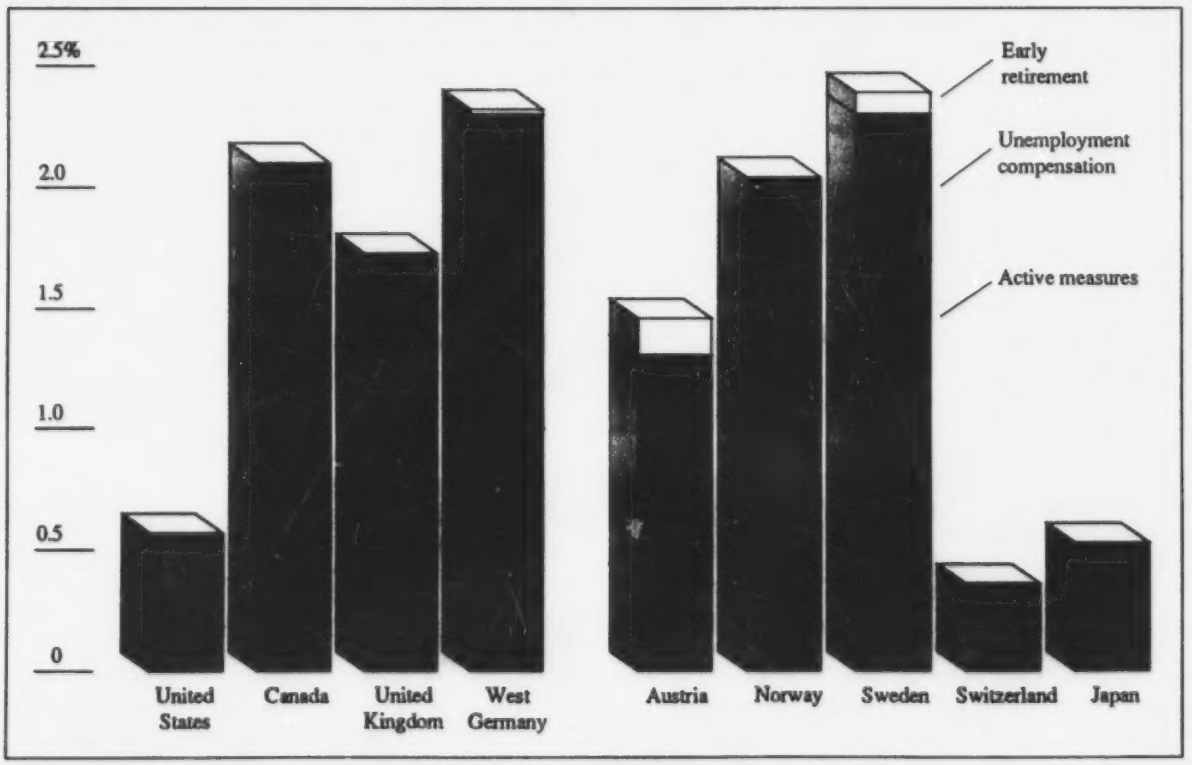
In recent years, with the introduction of the Canadian Jobs Strategy in 1985 and the new Labour Force Development Strategy in 1989, the federal government has shown that it wants to move away from income support and passive assistance expenditures, and it has begun to develop programs based on direct intervention in labour markets, emphasizing training, recycling, and the reintegration of workers. But as shown in Chart 3-8, the amount of resources allocated to these *active* labour-market measures in Canada is still a far cry from the corresponding amounts spent in West Germany, Sweden, or Norway. On the other hand, Canada led the group in 1989 with respect to the relative amount of public resources devoted to passive income-support measures.

As part of its Labour Force Development Strategy, the Canadian government is also encouraging businesses to increase their own spending on training. As well, many business and labour leaders are beginning to realize that they should actively participate in the management of public programs and policies. However, Canada is still far away from a system based on the tripartite, regionalized management of labour market programs. Tripartite consultation bodies (local advisory councils) were set up under the Canadian Jobs Strategy, but the results so far have not been very encouraging. In the summer of 1989, the Minister of Employment and Immigration invited the Canadian Labour Market and Productivity Centre, which brings together labour and management representatives, to play a major role in managing the process of public consultation on the new Labour Force Development Strategy. This may eventually lead to more direct participation by the social partners in the management of these programs.

At the moment, there are no participatory mechanisms for developing general economic policy in Canada. European-style social partnership has simply never taken root here. The 1985 Economic Summit organized by the federal

Chart 3-8

Public Expenditures on Labour Market Programs,[1] Selected Developed Countries, 1989



1 As a proportion of GDP.

SOURCE Organisation for Economic Co-operation and Development, "A new framework for labour market policies" (Paris, May 1990).

government might be viewed as an attempt in that direction, but the experiment was not followed up. There have been some attempts at the provincial level to implement tripartism – notably in Quebec between 1976 and 1980, and in Ontario, where the Premier's Council has produced two reports on competitiveness and adjustment since it was formed in 1986.

Governments do carry out consultations with the business world and with the provinces. But what consultation there is tends to be aimed at an elite; it is piecemeal and conducted on an ad hoc basis; and participants have the impression that decisions have already been made before their opinions are sought. That impression is reinforced by the cloak of secrecy surrounding federal (and provincial) budgets. Consultations carried out through royal commissions and itinerant parliamentary and senate committees enable various interest groups to express their viewpoints and to vent their frustrations on a specific issue, but these exercises tend to be adversarial rather than consensus-building.

As far as the setting of national economic policy is concerned, the technocratic approaches that developed in the 1940s have continued to this day. The fight against inflation in recent years has been based too much on the blunt instrument of monetary policy and too little on fiscal and other policy tools. Fundamentally, the aim of restrictive monetary policy – tight money and high interest rates – is to contain inflationary expectations. Because wage and price setters are slow to respond, this approach amounts to deliberately slowing down the economy until the desired outcome is obtained. The more slack there is in the labour market, the more successful is the policy. The higher is the unemployment rate, the more downward pressure is placed on wage demands and, thereby, on prices.

Canada did experiment with incomes policies in the latter part of the 1970s. From 1968 to 1970, the Prices and Incomes Commission tried vainly to gain the support of business and labour for voluntary wage and price controls, but it proved impossible to reach an agreement with the labour movement. A few years later (1975-78), mandatory wage and profit controls were imposed. In 1982, the "6&5" program imposed mandatory controls over the wages of public-sector employees alone, and several similar provincial programs were set up. While these policies were effective in slowing down inflationary pressures, governments have been disinclined to consider that option since then. It must be realized that policies such as these have nothing in common with the incomes policies followed by full-employment countries. In those countries, incomes policy refers to a process of *voluntary* negotiation leading to tripartite agreement on wages and other factors that influence incomes.

Conclusion

Unemployment is a measure of the capacity of the Canadian economy to respond to the forces of change in the world economy. Sustained increases in unemployment are a sign that individuals are experiencing hardship and that economic resources are being wasted.

We have identified rigidities in the Canadian economy that are closely related to wide regional variations in the industrial and occupational mix and in demographics. It would be unrealistic to suggest that provinces like Saskatchewan or Newfoundland will ever acquire an industrial structure similar to that of Ontario, but we see the widening gap in unemployment rates between Ontario and the other provinces, especially the West and Newfoundland, as a sign that industries in those provinces have experienced setbacks in the 1980s and that many workers have not made a successful adjustment to the economic realities of the 1980s and 1990s. We have also observed that some steps taken by governments in response to signs of stress in the economy are actually counterproductive, because they discourage the necessary adaptation.

Under some circumstances, regional diversity can be a source of strength. Regions that are enjoying good times can help to stabilize those that are facing hardship, through a combination of commercial links and fiscal transfers. But regional diversity also has some costs. In the 1970s, for example, the surge in world commodity prices favoured activity in western Canada and strengthened the Canadian dollar, causing considerable discomfort for the exporting industries in Ontario and Quebec. More recently, the signs of overheating in the Ontario economy in 1988 provoked a rise in interest rates and in the dollar, resulting in stress in the West, where the economic recovery was just gaining momentum – especially in Saskatchewan, where farm debts were excessive.

The presence of rigidity in the Canadian economy is disturbing for two reasons: first, it means that many Canadians are handicapped in their capacity to cope with the immense amount of change that is likely to take place during the 1990s; and second, if some parts of the economy do not respond to market signals, policies aimed at persuading Canadians to alter their behaviour must be more forceful. In that respect, we are particularly concerned that excessive dependence on a monetary policy stance that strives to

control inflation through credit restraint will periodically impose severe costs on some sectors or regions. We fear that those costs will accumulate over time, impairing Canada's capacity for adjustment.

This does not mean that Canadians should abandon the effort to control inflation, since it, too, does damage to the economy. Rather, it means that they must search for another policy lever that can focus on growth and employment. In examining the experience in countries that have been successful in keeping unemployment rates low without jeopardizing other aspects of economic performance, we have found differences with the Canadian approach that may explain the contrasting results with respect to unemployment. Our comparative survey suggests that Canada's approach is not likely to have any more success in meeting the challenges of unemployment in the years to come than it did in the 1980s.

The Council does not believe that the current rate of unemployment is acceptable and unavoidable. At the same time, we are convinced that controlling inflation is an essential goal. Thus it is clear that alternatives to the current strategy must be explored so that the control of inflation and the pursuit of full employment figure *side by side* as top economic priorities of government in this country.

It would not be practical for Canadians to simply adopt one of the foreign models. But we do believe that they can learn from the experience of others, by applying selected elements of foreign models to Canada's unique set of challenges and constraints.

4 Towards a New Policy Framework

How can Canada improve its ability to react appropriately to the structural changes that will take place during the 1990s? What are the ingredients of a better policy and institutional framework to replace the current, outdated strategy? Our objective, here, is not to propose a comprehensive blueprint, but to identify a range of options and point out the inherent obstacles.

As we saw in Chapter 3, some regions are adjusting less well than others to changes in the economic environment. Among other problems, their economies are saddled with rigidities that contribute to continuing high unemployment rates – e.g., regional economic structures that respond poorly to market signals; the unemployability of some workers whose skills do not match the needs of employers; and the presence of attitudes, brought about or reinforced by deficient economic policies, that reduce the interregional and interoccupational mobility of the labour force.

Clearly, regional economic structures and the operation of the labour market warrant a great deal of attention. New directions for regional development and labour market policies must be found. The most important feature of the new policy framework must be a better ability to fight unemployment and inflation simultaneously. It may be too late to avoid a recession in Canada in 1990-91, but if the pursuit of this objective is to be better managed in the future, Canada will need to commit itself to minimizing the adverse effects of periodic monetary restraint on output and employment opportunities while keeping inflationary pressures in check.

It is important that these policy objectives be seen as complementary. Policies that increase the flexibility of regional economies and the labour market are essential to the removal of the inflationary bottlenecks that limit the effectiveness of monetary restraint. At the same time, the success of policies aimed at the labour market and at regional development largely depends on a favourable economic climate. Anti-inflation policies that impose a heavy burden on many regions and sectors of the economy can seriously impede the adjustments in employment and investment that will be necessary during the 1990s. The success of other structural policies, such as the federal government's recent trade and tax initiatives, can also be jeopardized by a prolonged period of high interest rates.

Stronger Regional Economies

Strengthening the economic base of high-unemployment regions must remain a central objective of economic policy. In some provinces, the industrial and occupational mix, as well as the age and educational-attainment profile of the work force, account for as much as one-half of the disparity in unemployment rates with Ontario (see Chart 3-3).

Governments have been striving to achieve regional economic development for many decades, but the relative lack of success of these efforts has made many observers sceptical about the potential for changing the existing regional structures. Past efforts consisted mainly of attempts to influence the geographic distribution of economic activity through infrastructure spending and incentive grants aimed at attracting firms to the less-developed areas in order to locate or expand their operations there.

Diversification

The establishment of the Western Diversification Office and the Atlantic Canada Opportunities Agency in 1987 signalled a change in direction. The thrust of the federal government's strategy is now to promote diversification of the regional industrial base. The mandate of the new agencies is to stimulate entrepreneurship and to promote the creation of small and medium-sized businesses within the regions. Some provinces have also embraced this approach, introducing their own programs to foster entrepreneurship and the start-up of new businesses.

It is too early to assess whether or not this new approach will succeed where others have failed. Studies by the Economic Council, however, tend to indicate that several factors are essential for successful regional diversification.

First, it is necessary to ensure that the kind of technological infrastructure is in place that will enable individuals and firms in the regions to communicate efficiently and at reasonable cost with customers and suppliers in all parts of the world. The new infrastructure would make use of informal technology to facilitate communication, information development and exchange, and the production of the highest-quality goods or services. Regions that are not well equipped in the new infrastructure risk falling behind.

Second, workers must be trained to use these technologies, whether they are employed in processing fish, sawing timber, or designing a new kind of machinery. Human capital in technology-driven activities is becoming a decisive factor in economic performance. Thus provinces must invest in upgrading the quality and scope of their education systems while giving equal attention to training and retraining workers. Training makes workers socially mobile, enabling them to be more flexible with respect to occupation and industry.

Third, it is important to remove the barriers to innovation in the regions. This means removing obstacles to the start-up of new businesses. For example, unemployed workers who chose to start their own business were, until very recently, ineligible for unemployment insurance benefits. Experiments are now under way, as part of the Community Futures Program and the Labour Force Development Strategy, to allow workers to use their UI entitlements as the capital base for launching a new enterprise. A majority of OECD member countries already allow people to use their unemployment insurance benefits to start their own business and work in a self-employed capacity. Evaluation studies in France and the United Kingdom have shown that between 50 and 60 per cent of participants remain in business for over three years.[1]

Local Development

Top-down, bureaucracy-driven plans for regional development have fallen into disrepute. As a consequence, policymakers are paying more attention to the harnessing of local talents, expertise, and resources. During the past several years, we have witnessed the emergence of development efforts initiated by local communities in the form of cooperatives, new businesses, and local investments based on community entrepreneurship. The aim is to enable citizens to take charge of the economic well-being of their communities.

The Council has examined the potential contribution of community-based economic development and has sought to determine whether this option might work in Canada. Although this approach is still applied on an experimental basis in this country, we believe that it can play a useful and innovative role by complementing current government policies in the area of regional development. Our research, as well as work by other organizations, reveals encouraging examples of the positive spinoffs of development projects for local economies. Community development organizations are free to develop innovative ways of helping their communities and to adapt their solutions to their particular context; some of these initiatives can work only at the local level.

Consequently, the federal and provincial governments have recently begun to provide assistance to community economic development, and they seem inclined to increase their participation. We support the concept of community-based economic development; and, in our Statement, *From the Bottom Up*, we presented a series of recommendations aimed at improving the operation of community development initiatives and ensuring that public funds allocated for this purpose are used effectively.[2]

Labour Market Policies

No doubt, the key to adjusting to new trends in the world economy and to guarding against unforeseen shocks still lies with a labour force that is flexible, mobile, and ready to adjust to new jobs and to acquire new knowledge and new skills. Since the early 1980s, the need to enhance flexibility and adjustment in the labour market has been a subject of extensive discussion. A number of studies (such as *Adjusting to Win* and the CLMPC Task Forces on the Labour Force Development Strategy)[3] have stressed the importance of training policies, while others (such as the reports of the Macdonald and Forget Commissions) have called for fundamental changes in worker assistance programs.[4] Some of the recommendations made in those reports have helped to shape the thrust and format of current labour-market policies, but others, such as the Macdonald Commission's proposals for a "universal income security program" and a "transitional adjustment assistance program" – which would involve radical changes in the current system of worker assistance – did not seem to get the consideration they deserved, reflecting the reluctance of Canadians to effect major changes in the institutions that form the social safety net.

Our own research leads us to believe that policy priorities to promote adjustment in the labour market should include the following elements: a move from income support towards more-active labour-market policies; special attention to the employability of disadvantaged groups; more input from labour and business and from local communities in the design and delivery of labour market programs; and the adoption of workplace practices aimed at fostering internal adjustment.

An Active Stance

Regional disparities in unemployment are not limited to the mix of industries or characteristics of people who live in the various regions. Paradoxically, part of the adjustment

problem in some regions can be traced to past government efforts to correct regional disparities. As we pointed out in Chapter 3, while these programs have short-run beneficial effects, transfers to business – in the form of assistance to prevent job losses, temporary contracts to keep shipyards going, compensation payments to farmers, and so on – do not encourage the creation of a viable and durable production capacity.

Similarly, transfers to people (UI benefits and social welfare payments, in particular) can, in certain circumstances, foster attitudes that discourage re-entry into labour market activity and hinder the development of entrepreneurship and the creation of new businesses. By minimizing the economic losses associated with unemployment, for example, unemployment insurance dissuades many jobless persons from accepting a job offer in another field or in another region. In addition, studies have shown clearly how, in certain communities, workers exploit the UI program (with the tacit consent of employers) by tailoring their employment periods to the system's requirements for benefit eligibility. They have developed a type of community job-sharing system in which unemployment insurance acts as an implicit, albeit unintended, guaranteed-income system.[5]

Passive income support is a necessary element in the social safety net, but it must be combined with active measures that help workers to adapt to a changing world. The challenge for policymakers is to reconcile the needs for social protection with the efficient and smooth functioning of labour markets. Thus it becomes highly desirable to develop income transfer programs that offer stronger incentives for adjustment and mobility.

In *Good Jobs, Bad Jobs*, the Council recommended a gradual transition to an employment insurance program that would combine the functions of temporary income support, mobility incentives, and provision of job-counselling services in accordance with the identifiable needs of the unemployed.[6] An important part of the transition to this type of plan has to be the provision of improved opportunities for the unemployed to undertake training while still receiving unemployment insurance benefits. The UI scheme already provides a small proportion of the unemployed with access to training programs (under Section 26 of the Unemployment Insurance Act). In the proposed revisions to the act now before Parliament, the federal government seeks to widen the conditions under which UI recipients would be eligible for training. That is a step in the right direction, but much more needs to be done to transform the UI system into a truly active labour-market program.

Another important factor in the Council's proposals is a change in attitudes on the part of workers and management. Workers will have to appreciate the importance of acquiring new skills. It is in their interest to do so. Parents and communities must discourage young people from believing that being fishermen or farmers, generation after generation, is their preordained destiny – one that the state must accept without challenge. Without a change in "mindset," programs are bound to be ineffective.

A change in mindset, however, can only occur in a favourable legislative and cultural environment. Management must signal clearly to its employees that it values the acquisition of new skills. Employers must increase their own efforts to provide job-specific training and to display a positive attitude towards the acquisition of more general skills. Currently, private firms spend approximately $1.4 billion on training in Canada; on a per-employee basis, this represents less than half of what the private sector spends in the United States.[7] On the legislative front, government could accelerate the proposed transition by promoting the use of training investment funds, by enacting labour standards favouring leave without pay, by adopting tax provisions that permit deferred compensation, and so on.

The general goal here is to ensure that financial resources, whether raised through employer/employee contributions or through the public treasury, be allocated for the enhancement of employability. That objective is very different from the current emphasis of job programs, where for the most part people are paid to wait for a job opening to occur. In the approach proposed here, training, counselling, and, where necessary, relocation support would be the norm, not the exception. As we saw in Chapter 3, countries that have a healthy employment record spend more labour-market monies on such active policies and less on income support than Canada does.

Improving Employability

Some people tend to bear more than their share of unemployment: 60 per cent of all the time spent unemployed in Canada in 1986 was accounted for by only 29 per cent of all unemployed individuals.[8] The long-term unemployed (displaced older workers, in particular) belong to disadvantaged groups with serious problems of employability. This prevents them from finding a job even when the economy is buoyant. If these people were given the support needed to compete for new jobs, two objectives could be met at one time – equity, and greater efficiency in the labour market.

While all labour market programs in Canada remain accessible to the long-term unemployed, the Council has

examined the Job Development Program, which provides vocational training and work experience to any unemployed person who has been without a job for 24 of the previous 30 weeks. A follow-up survey conducted by the Department of Employment and Immigration shows that the program has been quite effective, by historical standards: 62 per cent of participants in the program in 1987-88 were employed or still in training after participating in the program; of these, 74 per cent used the skills acquired in their new jobs.[9] In 1988-89, approximately 89,000 workers (42 per cent of the eligible unemployed) participated in the program, at a total cost to the federal treasury of about $480 million.

Still, the Job Development Program could be improved in two ways. First, the program's capacity should be increased. Despite its low per-capita cost and its effectiveness, the program cannot meet the current demand, forcing the rejection of the applications of many eligible unemployed. Second, our research indicates that the individuals most likely to experience long-term unemployment can be identified at around the sixteenth week of unemployment, suggesting that it would be more efficient to allow the unemployed to participate in this program after the sixteenth week of unemployment rather than force them to waste two additional months of unnecessary waiting, as at present.[10] Both of these changes would require more funding, but given the effectiveness of the program in helping the long-term unemployed to find jobs, such a reallocation of funds merits serious consideration.

Emerging Partnerships

Reforming labour market policy is, of necessity, a long-term undertaking. Since it directly affects the lives and well-being of individuals, reform is bound to encounter a number of political and institutional obstacles. Under normal conditions, institutional arrangements can only be changed gradually, as a social consensus emerges about the need for change.

In some respects, the chances of forming such a consensus in Canada are better now than they have been for a long time. As we pointed out earlier, Canada has no tradition of European-style tripartism to deal with major economic issues. But encouraging signs of cooperation and consultation between the social partners have started to emerge, and they happen to be related to labour adjustment issues.

- At the national level, a promising example is provided by the Canadian Labour Market and Productivity Centre (CLMPC) consultations on the Labour Force Development Strategy, mentioned earlier. These consultations were the starting point for a productive dialogue between the authorities responsible for labour market policy and business, labour, and other private-sector representatives. In their report to the federal minister of Employment and Immigration, the private-sector representatives proposed the establishment of a national training board, composed of 22 private-sector members (eight each from business and labour), to oversee the priorities of the federal government's training budget and to coordinate the activities of some 75 local labour-market boards across the country.

- In Quebec, 12 regional forums and a province-wide forum on employment were held during the summer and fall of 1989. Representatives of the various interest groups sat down together to analyse the employment situation, identify the problems, and issue a statement for joint action.

- In British Columbia, the B.C. Task Force on Education and Training, composed of representatives of labour unions and employer organizations, was mandated in August 1989 to review employment- and training-related issues and submit recommendations to the provincial government.

- In Ontario, the Premier's Council has advised the government to delegate responsibility for training and other labour market programs to an Ontario Training and Adjustment Board, composed primarily of business and labour leaders. The Premier's Council also supported the decentralization of program decision making to regional and sectoral training committees. In effect, the board and its committees would become the major purchasers of training services from community colleges and private training firms. The board would have broad authority to make program and funding decisions regarding workplace training and adjustment.[11]

Several forms of sectoral cooperation between employers and employees have already been developed in recent years to deal with issues of industrial restructuring and labour adjustment. One example is the Canadian Steel Trade and Employment Congress (CSTEC), founded in 1986 by the United Steelworkers of America and the major steel producers to work together on questions of trade and employment affecting the steel industry. This partnership has produced an adjustment program for laid-off steel workers, designed and administered by the CSTEC. Another example can be found in the electrical and electronic products manufacturing industry, where employers and unions have agreed on the need to retrain and redeploy the work force in order to enable it to cope with a strong expansion of the industry. They formed a Joint Human Resource Committee in the electronics industry and launched a sectorwide training fund that includes provision for vocational training and upgrading, paid educational leave, and union-based education programs. Another interesting

experiment in partnership is CAMAQ, Quebec's *Centre d'adaptation de la main-d'œuvre en aérospatiale*. Formed in 1978, it brings employers and unions in the aerospace industry together with the federal and Quebec governments. Thanks in part to the federal government's Industrial Adjustment Service, an increasing number of similar sectoral committees are being established.

The success of sectoral labour/management joint strategies should not be too surprising. When the industry as a whole is experiencing serious difficulties, both workers and employers have a vested interest in overcoming them. Both parties are well acquainted with the situation and can make a unique contribution to the search for solutions.

The Economic Council strongly endorses the effort to build a partnership in the area of labour market programs, in the hope that it will be a first step towards a broader partnership at the national level. Over the long term, this could be expanded to include other aspects of economic management. Such a partnership would become a Canadian version of the institutions existing in other countries and would enhance Canada's capacity to adjust over the longer term.

Flexibility in the Workplace

Labour market policy is primarily concerned with the efficient allocation of workers among employers. But equally important for the process of adjustment is the way in which labour is reallocated within firms in response to foreign competition and technological change.

Effective labour adjustment *inside* the firm require a willingness to move away from traditional industrial relations and human-resource management practices. New approaches to work organization, labour relations, decision-making structures, and management style are essential to sustained improvements in productivity and competitiveness.

When efforts were made to introduce innovative practices over the past decade, they were often met with scepticism by workers and unions, especially since in some cases they were an ill-disguised attempt to keep the company or plant union-free. Case studies generally indicate that successful innovation depends on a determined effort to build channels of communication that promote mutual trust within the firm.[12]

One type of workplace innovation that has gained attention is the shift from fixed wages to various contingent-payment schemes, linking wage adjustment to the firm's profits, to the work unit's productivity, or to an individual worker's skills attainment. In theory, such compensation structures should have a favourable impact on the productivity of the plant. If diffused broadly, gain-sharing plans may also have desirable economic effects, as they can help to expand employment and to control inflation.[13]

Despite their widely acclaimed merits, these plans do not seem to be very popular in Canada. In its February 1984 budget, the federal government proposed a series of tax breaks to encourage the establishment of profit-sharing plans, but this proposal was later set aside. Broad diffusion of contingent-pay practices is unlikely to occur unless they are accompanied by changes in management practices to gain and sustain workers' trust and confidence in the new pay systems. These systems require the sharing of more information on current financial performance and future business plans. Unless they have wider access to information and an opportunity to influence these plans, workers and union leaders are likely to continue to prefer contracts that specify fixed wage adjustments.

Work organization and practices should be another area for innovation at the firm level, in order to overcome the inefficiencies associated with rigid and narrow job classification and job demarcation. However, workers view the rigid delineation of jobs as a necessary condition for the proper operation of the seniority system, which is now the primary determinant of wages and employment security in most firms. The transition to new forms of work organization will require employers and unions to find alternatives to the seniority system to provide the employment security sought by workers.[14]

In short, partnership may have its biggest role to play at the firm level. For this to happen, however, changes in decision making are required. Management will need to accept a broader role for workers and their representatives in the firm, in return for the changes in human-resource policies and practices that are needed for the company to compete in world markets. Increased worker involvement in the decision-making process can be achieved through various means and to various degrees, according to the specific circumstances of the firm: information-sharing, early consultations on technological change, employee stock-ownership or profit-sharing plans, or even worker's participation to management boards. Labour, in turn, will need to become more of a champion of innovation and adjustment in the workplace.

Such changes in attitude and behaviour will play an essential role in helping Canadians to adapt to the pressures for change in industries, occupations, and markets. But the

capacity to change is also affected by the strength and stability of economic growth.

Fighting Inflation

If there is one lesson to be learned from the economic policies of the 1980s, it is that fighting inflation through the exclusive use of tight monetary policy is very costly. The scenarios developed in Chapter 2 indicate that another recession, although it would likely be less severe than that of 1981-82, is a distinct possibility. Inflationary pressures have been persistent for more than a year and have led to a tightening of monetary policy. The government and the monetary authorities have stated that they will not tolerate a resurgence of inflation.

The problem is that the effectiveness of monetary policy seems to be tied directly to the severity of the economic slowdown it provokes. Only when the unemployment rate and the number of plant closures are rising does the policy seem to be truly successful in moderating wage and price increases. In this regard, the Macdonald Commission stated that

> no country in post-war history has been able to reduce embedded inflation through a shift to anti-inflationary demand-management policy without going through a recession, no matter how strongly the authorities have worded their commitment to reducing the growth of the money supply.[15]

Even if monetary austerity does not lead to a recession in the coming months, high interest rates and the overvalued dollar have already inflicted damage on some industries and regions. Still, inflation must be controlled, and finding a better way of controlling it will be one of the major policy challenges for the 1990s. Some of the weapons that could be used are social partnership, coordinated and credible inflation targets, more responsive wages, and coordinated fiscal policy.

Social Partnership

Based on the experience of the countries that have successfully practised a full-employment strategy, it might be advisable to rely more on the development of a social consensus and the adoption of guidelines or of a *voluntary incomes policy* to contain inflation. Tripartite systems based on central bargaining, coupled with compromise among the social partners – business, labour, and government – over a wide range of economic policy issues, seem to offer the key to controlling inflation without creating an unacceptable level of unemployment. Although the systems in other countries differ in important ways, they all rely on a form of voluntary incomes policy. This usually involves a general agreement or social contract at the national level between business, labour, and government – an agreement that sets out the changes in prices and wages that are deemed tolerable in the context of the economic strategy approved by the partners.

The tripartism needed to implement such a policy does not exist in Canada. One of the prerequisites is centralization of political and economic authority – the national employers' and labour-union organizations must represent the majority of businesses and workers, and they must have the power to negotiate and reach agreements that are binding upon their members. However, Canadian institutions, both economic and political, are characterized by fragmentation rather than centralization of power.

At the political level, the sharing of economic power between two levels of government means that a truly comprehensive agreement on wages and prices would require discussions not only between employers and workers, but also with all of the provincial governments.

Employers' and labour organizations are also marked by fragmented authority. In the early 1980s, there were approximately 480 national business associations.[16] The vast majority of them represented the interests of specific producers and did not belong to any central association authorized to speak on behalf of all businesses.

In 1989, the Canadian labour movement had no fewer than eight central union organizations, federations, or congresses, and a total of 291 national or international unions, not to mention the 809,000 members of unaffiliated unions.[17] The Canadian Labour Congress (CLC), which represents 2.3 million workers (58 per cent of all unionized workers) and 130 unions, is certainly the central federation best placed to undertake discussions at the national level. But the CLC cannot claim to speak on behalf of all unionized workers, especially since the power to organize and to bargain collectively lies mainly with union locals.

The fragmentation of Canada's political and economic institutions represents a serious obstacle to the formulation of a voluntary incomes policy in the short term. Consequently, the latter is not a realistic option for this country. That is not to imply that partnership is a dead issue: as we have seen above, partnership can play an important part in improving Canada's capacity to adjust. But a voluntary incomes policy can only be introduced successfully when social partnership becomes an accepted institution in the country.

Could not a mandatory incomes policy be imposed to regulate wages and prices, as was done under the Anti-Inflation Program between 1975 and 1978? According to a number of studies, the program resulted in a significant slowdown in wage increases, leading to a permanent drop in the rate of price increase of between 4 and 6 percentage points, yet avoiding an inflationary bubble when the controls were lifted.[18]

Wage and price controls, however, have many drawbacks. First, they constitute a serious infringement of the individual freedom to set prices and negotiate wages freely. Second, large-scale controls are burdensome in that they require a vast bureaucratic apparatus to administer and monitor them. Third, rigid rules for price and wage decisions create inefficiencies because relative price shifts are not allowed to occur. Fourth, there is always the danger of a serious outbreak of friction between the social partners, since controls are generally much more effective in restraining wage increases than in controlling prices or profit margins.[19]

The Council believes that Canada has nothing to gain by increasing tensions between the social partners. On the contrary, Canadians must make every effort to improve existing relations in order that the social partners may work together to improve the ability of the Canadian economy to adapt to external forces. We therefore reject the option of mandatory controls on wages and prices.

Coordinated and Credible Inflation Targets

The Bank of Canada has argued consistently in the past few years that "monetary policy should be conducted so as to achieve a pace of monetary expansion that promotes stability in the value of money. This means pursuing a policy aimed at achieving and maintaining stable prices."[20]

In firmly stating its long-term objective, the bank has attempted to convince economic agents that inflation will be controlled. Some analysts argue that such statements of objective can alter the patterns of wage and price behaviour and can thus control inflation at a lower cost in terms of lost output and employment.

Clear commitments by the Governor of the Bank of Canada and the Minister of Finance probably do help to shape the behaviour of business executives who exercise some control over the determination of wages and prices in their companies. But such statements are unlikely to influence the expectations of the general public or to have a direct influence on workers' wage demands. For the majority of Canadians, expectations about inflation are based on everyday experience rather than on official pronouncements.

It is when mortgage rates go up, when increases of up to 18 per cent in automobile insurance premiums are announced, when utilities such as Ontario Hydro and Hydro-Québec announce rate hikes to consumers of 7.8 and 15 per cent, respectively, when property and payroll taxes are rising, when the media debate the inflationary impact of the GST – it is then that people become convinced that inflation is accelerating, regardless of the actual trend in measured price indexes. To these people, the Bank of Canada's determination to achieve price stability does not seem feasible.

The problem is that there is an unfortunate lack of consistency between the statements made by the bank and the actions of federal, provincial, and municipal governments, including departments, corporations, and agencies. Many public officials do not consider the impact of their decisions on the rate of inflation. They do not realize that they are undermining the credibility of the stated objectives of the monetary authorities by creating a state of confusion in the public's mind that tends to entrench inflationary expectations and, in turn, to make monetary policy more restrictive than it need be. As a result, the Bank of Canada is made to appear to be solely responsible for the control of inflation.

In the view of the Council, controlling inflation is a policy objective that benefits Canadians in all walks of life, especially those on fixed incomes or with limited bargaining power; it also benefits the firms and workers who must compete in international markets. In a sense, inflation control is a public good, and this means that all Canadians should contribute to the avoidance of unnecessary pressures on prices and costs. That is especially true of public authorities whose actions are not subject to the discipline of the marketplace and who do not have much scope for achieving rapid gains in productivity to compensate for large price increases.

These observations lead to two main conclusions with respect to anti-inflation policies:

1 The Bank of Canada's objectives must be both clearly defined and perceived as feasible in the medium term, if there is to be an adjustment in inflation expectations; and

2 To fight inflation more effectively, all levels of government and all public authorities must assume greater responsibility for controlling inflation.

The Council believes that monetary policy would be more effective if the bank's objectives were stated in terms that

are easier to understand and to relate to. Currently, the bank's objective is defined as "achieving and maintaining stable prices." No time frame is given for the accomplishment of that goal. Furthermore, the term "stable prices" suggests a zero-inflation target – an objective whose feasibility is questionable in view of the fact that Canada has not achieved zero inflation for any significant length of time during the postwar era.

The Council also believes that governments and their agencies should play a more active role in the fight against inflation by making every effort to avoid increases in regulated prices and taxes that may be presented as excessive in terms of the objectives of anti-inflation policy. In addition, governments must be sensitive to the inflationary consequences of some of their initiatives and policies, such as environmental regulation or pay equity. To the extent that these policies lead to higher production costs, their impact on prices is fairly immediate. We are not suggesting that this type of intervention be abandoned, since it is often based on social choices, but it might be advisable to spread the changes over several years in order to dilute their inflationary impact.

In practical terms, the federal government should consider announcing specific benchmarks for the fight against inflation. These benchmarks should be compatible with the explicit objectives of the Bank of Canada if they are to achieve full credibility with the public. If the provinces are to assume responsibility in the fight against inflation, they should be involved in establishing the benchmarks. We believe that meetings of federal and provincial finance ministers, or possibly First Ministers, would be the appropriate forum for working out the guidelines for public-sector decisions on government charges (taxes, prices, user fees, and so on) and regulations. At the same time, each legislature should establish a standing committee whose mandate would be to review the decisions within its jurisdiction that appear to exceed the guidelines agreed at the ministerial level. We recognize that some decisions will exceed the guidelines for good reason, but we expect that others will fall short. Finally, Statistics Canada should be mandated to calculate the rate of increase in regulated prices and other government charges, so that the public may be informed about the contribution that governments (federal, provincial, and municipal) are making to the inflation process.

There is one precedent for this coordinated approach to fighting inflation – i.e., the "6&5" policy introduced in the June 1982 budget. That policy had several strong points: while remaining voluntary for the private sector, it gave the federal government's anti-inflation policy a degree of credibility and enabled economic agents to model their expectations on a norm that seemed realistic.[21]

It should be noted that this approach carries some risks. If set too low, the benchmarks will appear too optimistic and their impact on expectations will be limited. If set too high, they may drive expectations upward and result in higher inflation than would otherwise be the case. These disadvantages must, however, be weighed against the benefits that would flow from having more government decisions leaning in the same direction as monetary policy.

Wage Responsiveness

If prices and wages were more sensitive to variations in aggregate demand, they would react more quickly to tighter monetary conditions, instead of letting production and employment bear the brunt of the effects. In Canada, however, wages and prices react slowly to variations in aggregate demand. During the last recession, wage increases (as measured by effective increases in wage settlements or average weekly earnings) did not begin to decline in response to the economic slowdown until 18 months after unemployment had begun to rise.[22]

The causes of this inertia lie in the collective-bargaining process. First, collective agreements often cover two- or three-year periods; the average duration of contracts signed during the first half of 1990 was 29 months. Thus only a small number of wage contracts are negotiated in any given year, and they take into account the economic conditions prevailing at the time. Consequently, average wage levels are affected not only by the new agreements but also by the proportion of wages remaining unchanged and the implementation of deferred increases under existing contracts.

The overlap of contracts constitutes an additional source of inertia. When they are negotiating wages, labour and management take into consideration the current and future levels of compensation in similar industries or occupations. This factor is known as wage imitation. When contracts are not negotiated simultaneously, the adjustment process is slower because wage bargaining is based not only on current economic conditions but also on increases recently obtained in "benchmark" sectors. Canada and the United States are unique in that respect. As we saw earlier, in Japan and other industrialized countries, contracts are of short duration; in many cases, negotiations are conducted simultaneously. Shorter contracts and synchronized collective bargaining, even within a system of decentralized collective bargaining, would help to reduce the rigidity of wages and prices and to increase employment stability.

Although there seem to be undeniable advantages in moving to shorter contracts and more closely synchronized

negotiations, there are problems as well. Synchronized contracts of short duration would make the economy more vulnerable to rapid wage and price increases during periods of rising inflation. Monetary and fiscal authorities would have to react quickly to any signs of overheating in the economy. Other offsetting factors would be the additional bargaining costs, more-frequent work stoppages, and the reduced capacity of business to undertake long-term planning. A compromise solution would consist in keeping long-term contracts for nonwage benefits, with a provision for yearly negotiations on wages only.

Other ways of reducing wage inertia have been considered in recent years, notably gain-sharing plans. As we mentioned earlier, the use of profit- or productivity-sharing plans would make labour compensation more sensitive to the cycles in the economy, since the production and profits of the employer are linked directly to total demand. An economic slowdown, for example, would squeeze profits, and this, in turn, would be reflected in smaller bonuses for workers or reduced allocations to their profit-sharing accounts. Such an outcome would reduce the company's wage bill and enable the employer to hold on to workers that would otherwise have been laid off. In good times, when profits are strong, wages would be higher than they would have been under a fixed-rate system, as bonuses would kick in. Behind the operation of any contingent-compensation system is the notion that, over time, the total wage bill would be neither lower nor higher, on average, than under the current system of fixed wages. But employment would be much more stable.

Coordinated Fiscal Policy

Fiscal policy can play a greater role in the fight against inflation in two ways. First, greater coordination should be established between the federal government's fiscal and monetary policies and provincial fiscal policies. Second, the federal government should exhibit a consistent and firm approach to solving the debt problem.

In recent years, much attention has been devoted to the price that some regions of Canada have had to pay when one particular region, buoyed by a strong recovery, was riding an overheated economy while other regions had not yet fully recovered from the effects of the recession. Why slow down the country as a whole when the source of the inflation is localized?

The ideal solution would be to institute national economic policies that could be tailored to each region. With monetary policy, however, that is a practical impossibility. Because of the mobility of capital and of the absence of regional exchange rates, it is impossible to maintain different interest rates on loans in the same risk category within the same monetary zone. On the other hand, differentiation of fiscal policy remains a possibility, at least in theory. While the federal government's fiscal policy as a whole might be restrictive, for example, certain regions could be exempted, although this type of differential treatment would likely encounter serious political resistance.[23]

Another way of differentiating fiscal policy is for the provincial governments to assume greater responsibility for the fight against inflation through their own fiscal policies. For example, it has been argued that, during the very strong recovery that followed the 1981-82 recession, the Ontario government had several excellent opportunities, particularly in 1988, to reduce overheating in its economy by adopting more restrictive budgets.[24] Instead, the budgets that were actually adopted were rather expansionary. And because Ontario decided to increase spending in areas governed by shared-cost agreements, federal expenditures also had to be increased, making the process of deficit reduction more difficult. So it appears that, at times, provincial actions have fuelled inflationary pressures rather than moderated them, with the result that monetary policy has had to be tightened further.

It is quite evident that the lack of coordination on fiscal decisions has made fiscal policy inefficient and, at times, counterproductive. The risk of inefficiency increases as the presence of provincial and local governments in the economy expands – they now account for 63.3 per cent of total public spending in Canada. Federal/provincial coordination has been tried in the past, but these efforts have foundered, sooner or later, either because of conflicting priorities or because of the temptation to shift political costs to another government. Nevertheless, there is compelling evidence that the costs of not coordinating policy are high. Thus we must stress the need to ensure greater coordination of budgetary policy between the provinces and the federal government.

Better coordination is also required between federal fiscal and monetary policies. The inconsistency between the stated policy of the Bank of Canada and the basic assumptions in the February 1990 budget is symbolic of this problem. The simulations in Chapter 2 make it clear that a greater harmonization of those two major levers of economic policy is essential. A fiscal policy that shoulders some of the responsibility for moderating the pace of growth at a time of inflation pressure clearly creates more favourable conditions for the Bank of Canada to achieve its goal of controlling inflation. Conversely, the speed with which the central bank pursues its longer-term objective has major

repercussions for the capacity of the government to achieve deficit reduction. A single-minded pursuit of lower inflation could throw the federal government' fiscal strategy into disarray. There are certainly times when the central bank has to act firmly and quickly to prevent inflation from getting out of control, but once the tendency for prices to accelerate has been contained, the Bank of Canada has room to take into account other indicators of economic performance, including high employment and deficit reduction. Of course, this sense of partnership would be strongly reinforced if federal and provincial finance ministers were to adopt the anti-inflation benchmarks proposed earlier.

Conclusion

Canadians must be prepared to question and redefine the current institutional and policy framework for fighting inflation and for promoting economic development. Failure to do so could lead to high unemployment levels and the persistence of rigidities that could limit the growth potential of the economy for the rest of the decade, especially in regions where adjustment has been sluggish in the past.

In Chapter 3, we described several European models for economic policymaking that have been successful in building a social consensus on the objectives of full employment and stable prices. We concluded that none of these models could be successfully transplanted to Canada. We have set out here a number of ideas that could eventually lead to the development of a unique Canadian model, constructed over time out of the experience of joint problem-solving. These ideas are worth trying in the short-to-medium run because they offer a chance to work out some of the immediate and intractable conflicts among policy goals. They are also potentially viable in the medium-to-long term because they offer a chance to build new institutional relationships founded on a sense of partnership.

If the potential gains from any of the options reviewed in this chapter are to be achieved, Canadians will have to demonstrate the political will to solve problems in a cooperative effort. The transition to a more effective economic policy framework can only come about if federal and provincial governments, along with business and labour leaders, are prepared to admit that there is something fundamentally wrong with the way we have tried to solve economic problems in the past.

Many employers tend to leave the responsibility for economic management entirely to governments when they should understand that they have a greater role to play as society adapts to the new global realities of the 1990s. As employers gain more power through deregulation and greater mobility of capital and resources, they must also take on more responsibility in such fields as investment in training and protection of the environment and in ensuring development of new infrastructure, such as telecommunications and transportation.

The Council recognizes that many Canadians are finding it difficult to understand and respond to the changes taking place in the workplace and to stretch their budgets when interest rates are high and jobs less secure than in earlier decades. We are aware of the paradox between the apparent prosperity of Canadian society and the economic insecurity faced by many families that was highlighted in the 26th Annual Review. But we have to point out that Canadians are going to have to scale down their expectations regarding the capacity of governments to solve their problems. National governments are losing some of their traditional levers of power, and the federal government in particular is experiencing serious financial difficulties.

Finally, we cannot be optimistic about Canada's ability to cope with the transitions ahead unless greater maturity is instilled into federal/provincial relations – i.e., unless the federal government genuinely consults its provincial counterparts, and unless the provinces treat the federal government as a colleague rather than a scapegoat. The recent deadlock on the Meech Lake Accord casts a dark shadow on the future. But the costs of the absence of policy coordination documented in this Review must convince governments to rise above the painful divisions of the constitutional debate. If they do not, Canada's options will be limited and unappealing.

The Council believes that a collective effort to control inflation and to fight unemployment would not only put the Canadian economy on a healthy growth path for the medium term but would also help Canadian society through a vital transition to a policy framework suited to the realities of the 1990s.

Appendices

Table A-1

Destination of Canadian Exports, 1971 and 1987

	1971	1987
	(Per cent)	
Total exports to:		
United States	68.5	75.7
G-4 countries[1]	12.1	5.8
Japan	4.6	5.7
Pacific Rim less Japan	3.2	4.4
COMECON countries	1.3	1.0
Other countries	10.3	7.3
Total	100.0	100.0
United States		
Food and beverages[2]	31.4	43.6
Other crude materials	49.3	46.7
Fuel	94.9	85.6
Manufactured products	79.6	85.5
G-4 countries		
Food and beverages[2]	20.9	6.7
Other crude materials	21.7	16.5
Fuel	0.4	0.5
Manufactured products	8.3	3.9
Japan		
Food and beverages[2]	8.6	11.5
Other crude materials	12.5	16.1
Fuel	4.3	10.1
Manufactured products	1.0	1.8
Pacific Rim less Japan		
Food and beverages[2]	11.0	10.5
Other crude materials	2.3	7.9
Fuel	--	2.3
Manufactured products	2.4	3.1
COMECON countries		
Food and beverages[2]	8.5	9.6
Other crude materials	0.6	0.5
Fuel	--	--
Manufactured products	0.2	0.2
Other countries		
Food and beverages[2]	19.6	18.0
Other crude materials	13.6	12.3
Fuel	0.3	1.4
Manufactured products	8.4	5.6

1 United Kingdom, France, West Germany, and Italy.
2 Includes grain and oilseeds.
SOURCE Estimates by the Economic Council of Canada, based on Statistics Canada's World Trade Database.

B The Impact of Changes in Trade and in the Composition of Inputs on Jobs, 1986/81

The results reported in Table 1-2 (in Chapter 1) and Table B-1 in this appendix are developed from the 1981 and the 1986 Make, Use, and Final Demand Matrices associated with the system of input-output tables published by Statistics Canada. By appropriately organizing the Make, Use, and Final Demand Matrices, it is possible to determine worker requirement in 1986 for a variety of counterfactual assumptions. In particular, it is possible to assess the impact on worker requirements that has occurred because changes in the Use (or "recipe") matrix have taken place between 1981 and 1986. If a given product requires its manufacturer to use a different mix of intermediate inputs, this will, in turn, influence the industrial composition of the labour content of the final product. That impact is identified with changes in the composition of inputs. In addition, the impact on worker requirements of changes to the level and industrial composition of final demand can also be assessed, including the impact of changes in the level and industrial composition of exports and imports between 1981 and 1986.

Such calculations should not be confused with those obtained from a macroeconometric model where a fully integrated income effect is also taken into account. The results reported here are associated only with the direct and indirect (through the backward-looking chain of inputs) effect of intermediate and final-demand changes on worker requirements.

In Table 1-2, the results of Column 2 are obtained by using the 1981 Use Matrix to determine 1986 worker requirements, given the 1986 level and industrial composition of final demand. The results of Column 3 are obtained by using the 1986 Use Matrix to determine 1986 worker requirements, given the 1981 level of exports. The results of Column 4 are obtained by using the 1986 Use Matrix to determine 1986 worker requirements, given the 1981 industrial composition of exports maintained at the 1986 level of demand. The results of Column 5 are obtained by using the 1986 Use Matrix to determine 1986 worker requirements, given the 1981 level of imports. This calculation assumes that import substitution has taken place. The results of Column 6 are obtained by using the 1986 Use Matrix to determine 1986 worker requirements, given the 1981 industrial composition of imports maintained at the 1986 import level of demand. This calculation also assumes that import substitution has taken place. The results contained in Column 7 reflect the fact that interactive nonlinearities arise when all effects are assessed simultaneously. The results contained in Column 8 are obtained by using the 1981 Use Matrix to determine 1986 worker requirements, given the level and composition of 1981 exports and imports. The level and composition of consumption, investment, and government spending remains unchanged from that of 1986. For the industrial detail associated with these calculations, see Table B-1.

Table B-1

Impact of Changes in Trade and in the Composition of Inputs on Jobs, Canada, 1986/81

	Employment, 1986	Change in composition of inputs[1]	Total impact[2]
		(Thousands of workers)	
Primary			
Agriculture, fishing, forestry	579.8	–13.1	–10.7
Crude petroleum and natural gas	40.6	–4.6	7.6
Metal and non-metal mining	109.4	–21.6	–35.3
Subtotal	729.8	–39.3	–38.4
Manufacturing			
Food	194.4	1.4	–1.2
Beverages	31.7	1.5	0.1
Tobacco products	7.0	0.1	–0.2
Rubber products	25.8	0.1	–0.9
Plastic products	41.4	7.6	7.5
Leather	23.3	0.2	–8.2
Textile and textile products	59.2	8.6	–5.7
Clothing	114.0	5.6	–13.0
Wood	110.9	7.6	19.3
Furniture and fixtures	55.8	2.7	6.1
Paper and allied products	116.2	0.8	3.7
Printing and publishing	123.9	3.5	5.9
Primary metal	102.3	–20.7	–38.4
Metal fabricating	148.0	–15.7	–20.7
Machinery	78.0	–17.5	–58.1
Transportation equipment	214.2	8.1	21.7
Electrical products	135.1	28.1	9.3
Nonmetallic mineral products	53.3	–0.1	1.1
Petroleum and coal products	14.0	–1.8	–2.6
Chemical and chemical products	86.5	10.7	–3.8
Miscellaneous manufacturing	69.3	–0.9	–2.5
Subtotal	1,804.0	29.9	–80.5
Other			
Construction	674.6	–10.7	–8.4
Regulated industries	766.5	5.7	23.9
Trade	1,993.5	20.5	33.4
Finance and insurance	605.0	24.3	43.3
Business services	551.6	9.7	48.1
Educational and health services	181.6	1.4	1.2
Other services	1,255.1	–38.4	–27.8
Subtotal	6,028.0	12.6	113.7
Total	8,561.8	3.2	–5.2

1 Includes only the impact on worker requirements of changes in the composition of inputs.

2 Includes not only the impact (worker requirements) of changes in the composition of inputs but also the impact of changes in the level and composition of exports and imports.

Source Estimates by the Economic Council of Canada, based on Statistics Canada, Input-Output Tables, 1981 and 1986.

C United States Base Case and Alternatives

The U.S. Base Case

Is it possible for the United States to improve its internal and external deficit position while maintaining sustained growth and stable inflation? In the current circumstances, the key to a successful transition is to introduce substantial deficit-reducing measures, to wager an active fight against the acceleration of inflation in the medium-to-long run, and to foster harmonious economic developments in Europe and Asia. At most, two of the three conditions necessary to ensure a successful transition are currently present.

The most significant aspect of the external environment has been the different patterns of growth in Europe, North America, and Asia. Real growth in the Asia-Pacific region and in Europe has been stimulated by investment spending. This is expected to continue, though at a slower pace. By comparison, in the United States, growth during 1989 and the early part of 1990 has been much slower. The United States has tightened credit during the last 18 months in order to contain inflationary pressures. The federal funds rate jumped 300 basis points in 1988-89, and then dropped by roughly 150 basis points. We expect this downward trend to continue. Nevertheless, credit will remain relatively tight in real terms, compared with the conditions that existed in 1987 (partly due to tougher bank regulation).

Because of this recent period of tight credit, real growth has decelerated, and the initial acceleration of inflation has been contained. In 1990 and on into 1991, output and employment will grow at a pace that will make it possible to achieve a better balance between demand and capacity, enabling the monetary authorities to loosen credit while monitoring closely what could become an explosive inflationary situation. The details of the base-case projection for the U.S. economy are contained in Table C-1.

In the base case, the federal deficit shrinks by about US$30 billion a year, reaching near balance by 1995. We assume that the United States will implement a policy package that will include tax increases, lower military spending on strategic goods, and restrictions on spending related to social programs (including medicare). However, the deficit target of $64 billion for fiscal year 1991-92 contained in the Gramm-Rudman-Hollings deficit-reduction act will not be achieved without more changes to fiscal policy than are contained in the base case. Recent estimates of the deficit run as high as $230 billion for fiscal year 1991-92 when the cost of the savings-and-loan bailout is included. If the latter is excluded, a provision of over $100 billion would still be required to meet the $64-billion target.

One benefit from an improved fiscal position of the federal government in the base case is an increase in national savings relative to GNP. As a result, pressures in credit markets diminish, as does the need for capital inflows. This leads to a modest reduction in the current-account deficit relative to GNP. While depreciation of the U.S. dollar by about 15 per cent makes a positive contribution, several other factors retard improvement, including the "J-curve effect" – a deterioration in the terms of trade and an unfavourable shift in the income component of the trade surplus, caused by past growth in the foreign debt.

More Restrictive Fiscal Policy

The base case includes some elements of fiscal policy that have not yet been agreed to by the U.S. Administration and Congress. What is the relation between a renewed commitment to substantive changes in fiscal policy and economic performance in the United States? The second scenario assesses the impact on the U.S. deficit of additional fiscal measures not included in the base case; the result is a (static) cumulative reduction of over $160 billion in the deficit between now and 1995 (Table C-2, "More restrictive fiscal policy"). This reduces by half the average deficit/GNP ratio for the period 1991-95. In fact, the budget position moves to a substantial surplus by 1995.

The benefits of such fiscal action are clear-cut: real interest rates decline, leading to more rapid growth in business investment; the depreciation of the dollar leads to stronger export growth; and more rapid accumulation of business capital improves labour productivity and raises real incomes. The current-account deficit improves, and reduced public consumption leads to a lower foreign debt. All of this points to higher living standards in the future. Fiscal restraint in the near term brings the benefit of lower real interest rates later on.

Table C-1

U.S. Base Case: Selected Indicators, 1986-95

	1990	1991	1992	1993	1994	1995	Average, 1986-90	Average, 1991-95
External environment								
				(U.S. dollars/barrel)				
Price of crude petroleum	18.00	18.00	18.81	19.63	20.67	21.76	16.64	19.77
				(Per cent)				
Growth in:								
Producer price index[1]	14.2	9.2	8.9	9.1	7.9	7.5	12.0	8.5
Real GNP[2]	3.3	3.2	3.4	3.3	3.2	3.2	3.6	3.3
United States								
Growth in:								
Real GNP	2.1	2.2	2.4	2.6	2.8	2.7	3.2	2.6
GNP deflator	4.2	4.0	4.2	4.2	4.3	4.4	3.5	4.2
Nominal GNP	6.4	6.3	6.7	7.0	7.3	7.2	6.8	6.9
Consumer price index	4.9	4.3	4.6	4.8	4.9	4.9	3.9	4.7
Civilian labour force	1.4	1.6	1.4	1.4	1.4	1.3	1.7	1.4
Labour productivity	0.7	1.3	1.3	1.5	1.6	1.4	1.4	1.4
Level of:								
Unemployment rate	5.5	5.8	5.6	5.6	5.6	5.5	5.9	5.6
Participation rate	66.8	67.2	67.6	67.9	68.2	68.4	66.0	67.9
Federal funds rate	8.4	8.5	8.8	8.6	8.4	8.5	7.7	8.6
As a proportion of GNP:								
Federal deficit	−2.8	−2.2	−1.8	−1.2	−0.6	−0.2	−3.4	−1.2
Current account balance	−1.7	−1.8	−1.7	−1.6	−1.4	−1.2	−2.5	−1.5
				(Dollars)				
Minimum wage	3.69	4.14	4.25	4.50	4.75	5.00	3.42	4.53
				(Per cent)				
Growth in:								
Federal wages	4.7	4.4	4.8	3.5	5.4	5.6	4.5	4.7
State and local wages	4.4	5.3	5.3	5.5	5.6	5.6	5.0	5.5
Level of tax rates:								
Personal income tax	11.5	11.6	11.6	11.6	11.6	11.5	11.5	11.6
Statutory corporate income tax	34.0	34.0	34.0	34.0	34.0	34.0	37.6	34.0
Growth in real federal expenditure:								
Defence	−1.3	−2.7	−3.3	−3.2	−3.1	−3.1	1.4	−3.1
Goods and services[3]	1.1	0.8	0.8	0.7	0.6	0.6	2.3	0.7
Total	0.7	−1.4	−2.1	−2.1	−1.8	−1.7	0.8	−1.8
				(1980 = 100)				
U.S. dollar index	190.6	194.8	197.3	202.2	204.0	204.5	163.4	200.5

1 Trade-weighted index of producer price indices (excluding food and energy) of U.S. trading partners.
2 Trade-weighted index of real GNP of U.S. trading partners.
3 Excluding Commodity Credit Corporation payments.
SOURCE Estimates by the Economic Council of Canada, based on projections from the WEFA Group.

Unfavourable Developments Abroad

There is the possibility that events in Japan and Europe stemming from demand pressures and Eastern European integration into the market system will lead monetary authorities to take a more cautious approach towards inflationary pressure. The result would be higher real interest rates that aggravate the current slowdown (Table C-2, "U.S. recession"). Higher interest rates in Japan and Europe would first lead to downward pressure on the U.S. dollar. Eventually, to avoid the inflationary impact of a weaker dollar, the United States would have to raise interest rates. The slowdown in output growth abroad and the tightening of domestic credit would be enough to further slow down the U.S. economy to the point of recession in 1992. The result would be a wide swing in the growth rate, with real interest rates falling sharply, once recession conditions were fully established. The outcome would be a loss in production, a temporary increase in unemployment rates, and some reduction in the inflation rate. By the end of the output cycle, the economy would move back to a more normal performance. But the bill for a slightly lower inflation rate would be lower output and higher unemployment rates for three successive years.

Using Monetary Policy to Target Inflation in the 3-Per-Cent Range

What if the U.S. Federal Reserve Board decides to lower its inflation target further – to 3 per cent, as opposed to the 4.5 per cent assumed in the base case – over the medium term? How much credit tightening would be necessary?

There are two possible outcomes, depending on the degree of rigidity in nominal wage and price setting. If we assume, first, expectations that look backward and not forward, combined with more restrictive monetary policy, interest rates would have to increase nearly 200 basis points initially and to remain 70 basis points higher than the base case in order to meet a 3-per-cent inflation target by 1995 (Table C-2, "Inflation targeting, no cooperation"). In short, real interest rates would remain in the 5-to-6-per-cent range for most of the period. Tighter monetary policy would, under these circumstances, severely curtail the growth of demand and raise unemployment rates by about 1.3 percentage points. In 1992, the unemployment rate would reach about 7 per cent. In addition, an output gap of about 2 percentage points annually would be required for about five years. At the same time, there would be a sharp deterioration in the federal budgetary situation because of slower growth and higher debt-service costs.

The cost of fighting inflation through monetary restraint is substantially reduced if both the government and the private sector adjust their expectations of inflation more quickly (Table C-2, "Inflation targeting, with cooperation"). In the second case, we assume that inflation expectations are revised (downward) quickly. Under these circumstances, the United States could achieve a 3-per-cent inflation target by 1995 without triggering as large a decline in production or as great an increase in the unemployment rate. An additional benefit is that the budgetary situation would not deteriorate as much as in the first case.

The Effect of Higher Oil Prices

Political instability in the Middle East during the month of August made it difficult to pinpoint the future level of oil prices. A global supply/demand analysis does not support the price range of US$24 to US$28/barrel quoted on world markets in August unless we assume a managed system of production quotas. Even if prices were to remain at that level, there are reasons to believe that the disruptions that followed in the wake of the oil price shocks of the 1970s would not recur with the same intensity. Conservation and greater substitution possibilities among energy sources have made the industrialized countries less dependent on oil, and the better-integrated financial markets will hasten the recycling of petrodollars and help sustain aggregate demand in oil-consuming countries. Finally, monetary authorities in those economies have improved their skill at handling supply shocks in order to avoid costly increases in inflation expectations.

The current level of crude oil stocks, a more open trading system, and changes in global politics have made it much more difficult for a single producer to disrupt the world supply/demand situation. In particular, there is evidence that some oil-producing countries are prepared to increase their output in order to offset any supply shortfall from other sources. Nevertheless, it is useful to explore the impacts of a *sustained* rise in world oil prices.

The U.S. base case assumes a price profile for the refinery acquisition cost of US$18/barrel in both 1990 and 1991, trending upward to $21.76/barrel by 1995. The high-oil-price alternative simulation reported here assumes that the refinery acquisition cost rises by $7.50/barrel to $25.50 during the fourth quarter of 1990. This increase is sustained up to 1995, when the price of a barrel reaches $29.26.

As the United States is a net importer of energy, the rise in the price of oil would result in a transfer of income to countries that are net oil exporters. A lower level of income

Table C-2

U.S. Alternative Scenarios: Selected Indicators, 1991-95

	1991	1992	1993	1994	1995	Average, 1991-95
			(Per cent)			
Change in:						
Real GNP						
Base case	2.2	2.4	2.6	2.8	2.7	2.5
More restrictive fiscal policy	2.4	2.6	2.5	2.8	2.7	2.6
Inflation targeting, no cooperation	0.4	1.5	3.3	3.2	2.8	2.2
Inflation targeting, with cooperation	1.3	1.9	2.9	2.8	2.5	2.3
U.S. recession	1.6	0.9	4.1	3.8	2.7	2.6
Higher oil price[1]	1.5	2.0	3.0	2.9	2.7	2.4
GNP deflator						
Base case	4.0	4.2	4.2	4.3	4.4	4.2
More restrictive fiscal policy	3.9	4.2	4.3	4.3	4.4	4.2
Inflation targeting, no cooperation	3.9	3.5	3.2	3.4	3.2	3.4
Inflation targeting, with cooperation	3.8	3.6	3.4	3.4	3.1	3.5
U.S. recession	4.0	4.1	3.6	3.8	4.0	3.9
Higher oil price[1]	4.3	4.4	3.9	4.1	4.3	4.2
Level of:						
Unemployment rate						
Base case	5.8	5.6	5.6	5.6	5.5	5.6
More restrictive fiscal policy	5.7	5.5	5.6	5.7	5.7	5.6
Inflation targeting, no cooperation	6.3	6.9	6.7	6.3	6.0	6.4
Inflation targeting, with cooperation	6.1	6.3	6.2	6.1	6.1	6.2
U.S. recession	5.9	6.6	6.2	5.6	5.3	5.9
Higher oil price[1]	6.5	6.4	6.3	6.2	6.0	6.3
Federal funds rate						
Base case	8.5	8.8	8.6	8.4	8.5	8.6
More restrictive fiscal policy	8.0	8.6	8.3	8.0	8.1	8.2
Inflation targeting, no cooperation	10.4	9.7	9.1	9.1	9.2	9.5
Inflation targeting, with cooperation	9.4	9.2	8.8	8.7	8.8	9.0
U.S. recession	10.1	9.7	7.3	8.0	8.1	8.6
Higher oil price[1]	9.1	9.1	8.4	8.1	8.1	8.6
			(1981 = 100)			
Exchange rate						
Base case	194.8	197.3	202.2	204.0	204.5	200.5
More restrictive fiscal policy	192.5	194.5	199.0	200.6	201.0	197.5
Inflation targeting, no cooperation	204.5	207.8	212.9	216.7	219.3	212.2
Inflation targeting, with cooperation	199.7	202.9	208.3	211.7	214.2	207.4
U.S. recession	193.9	200.8	206.7	207.8	208.5	203.5
Higher oil price[1]	193.9	197.3	203.4	205.6	206.5	201.3
			(Per cent)			
As a proportion of GNP:						
Federal budget deficit						
Base case	–2.2	–1.8	–1.2	–0.6	–0.2	–1.2
More restrictive fiscal policy	–2.0	–1.3	–0.6	0.2	0.8	–0.6
Inflation targeting, no cooperation	–2.8	–2.7	–2.0	–1.4	–1.0	–2.0

Table C-2 (cont'd.)

	1991	1992	1993	1994	1995	Average, 1991-95
			(Per cent)			
Inflation targeting, with cooperation	–2.6	–2.3	–1.7	–1.1	–0.8	–1.7
U.S. recession	–2.5	–2.6	–1.5	–0.6	–0.2	–1.5
Higher oil price[1]	–3.3	–2.5	–1.8	–1.1	–0.7	–1.9
Current-account deficit						
Base case	–1.8	–1.7	–1.6	–1.4	–1.2	–1.5
More restrictive fiscal policy	–1.7	–1.6	–1.3	–1.0	–0.8	–1.3
Inflation targeting, no cooperation	–1.7	–1.6	–1.6	–1.5	–1.4	–1.6
Inflation targeting, with cooperation	–1.7	–1.6	–1.5	–1.3	–1.1	–1.4
U.S. recession	–1.7	–1.4	–1.2	–1.3	–1.1	–1.3
Higher oil price[1]	–2.1	–1.9	–1.4	–1.1	–0.9	–1.5

1 In 1990 and 1991, the average refinery acquisition cost stood at US$18/barrel in the base case. In the high-oil-price alternative, this key price was raised to US$20.80 in 1990 and US$25.50 in 1991. Thereafter, the base-case trend was maintained. By 1995, a level of US$29.26 was reached in the high-oil-price alternative, as opposed to US$21.76 in the base case – a difference of $7.50/barrel.

Source Economic Council of Canada, based on projections from the WEFA group.

would mean lower real wages and reduced domestic expenditures. The direct effect of higher oil price would also push domestic prices higher. The adjustment to a new, lower level of income would be accompanied by a fall in output and a rise in unemployment. This is what the higher-oil-price alternative for the United States shows.

The simulation that we performed assumes that the monetary authorities will not tolerate any permanent increase in the price level. This is proxied by leaving the level of reserves in the financial system unchanged from the base case. Nevertheless, prices rise, and inflation (GDP deflator) is 0.3 percentage points above the base-case projection in 1991, with an additional 0.2 percentage points in 1992. Prices are also affected by a slight depreciation of the dollar vis-à-vis the G-4 (the currencies of Japan, Britain, Germany, and France). Output growth is lowered by about half a percentage point per year in both 1991 and 1992. The reduction in output growth is also influenced by the assumption that the United States' trading partners will be negatively affected by the shock. Their demand for U.S. products will be lowered. Table C-2 indicates that, despite the reduction in output growth relative to the base case, an oil-price shock of this magnitude by itself is not expected to bring the U.S. economy into recession.

D The Effect of Higher Oil Prices in Canada

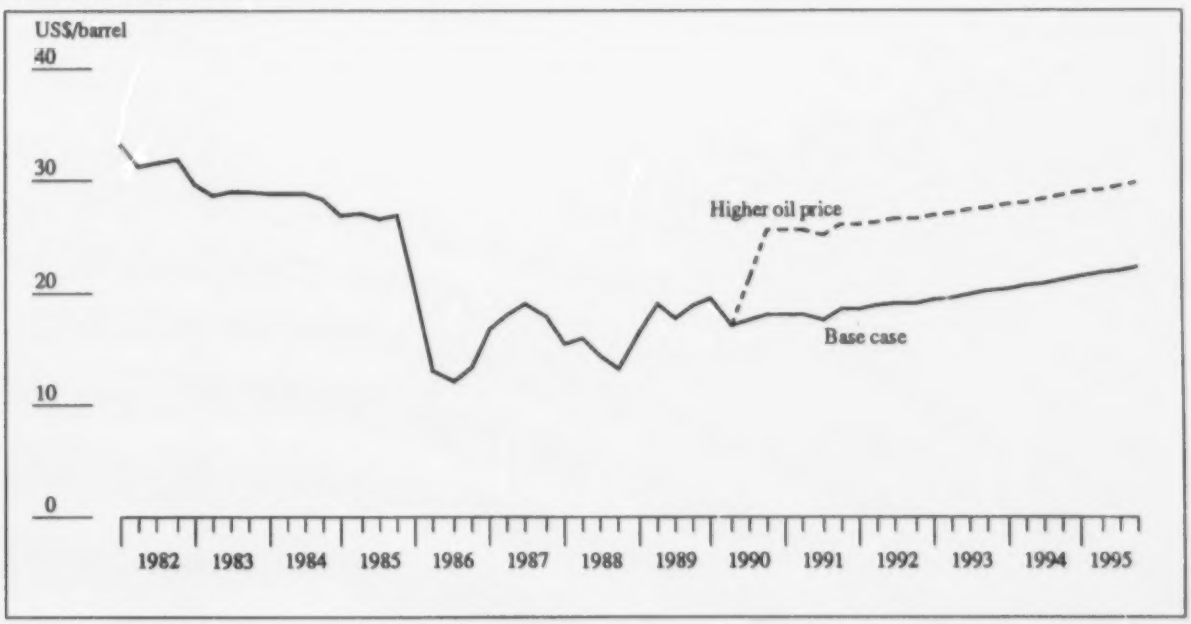
The U.S. base case described in Appendix C assumes a price profile based on the refinery acquisition cost of US$18/barrel in both 1990 and 1991, trending upward to US$21.76/barrel by 1995. The pattern for Canadian prices, although slightly higher, follows closely that for the United States (Chart D-1). The Canadian high-oil-price alternative reported here uses as an input the U.S. oil-price case documented in Appendix C. Thus the Canadian case incorporates the spillover effects from the United States as well as from the rest of the world.

Because Canada is a net exporter of energy, higher oil prices improve Canada's terms of trade, and the Canadian current-account position shows some improvement (Table D-1). This shock is therefore favourable to Canada in the longer run. However, the adjustment of the industrialized countries to the shock and the effect of higher oil prices on inflation in Canada are likely to make Canadians worse off in the short run.

The increase in oil prices reduces real output growth in 1991 and 1992 and adds 0.3 percentage points to the inflation rate in 1991. The speed with which these near-term losses are made up depends, among other things, on how quickly investment decisions in the energy sector respond to higher world prices, on how fast our trading partners (who are generally net oil importers and therefore negatively affected) recover, and on how wages in the nonenergy sectors react to the loss of real income caused by the shock. The calculations assume that the monetary authorities will act to guard against any permanent increase in the price level – that is, money supply is held at the base-case level.

Chart D-1

Crude Oil Price, 1982-95[1]



1 Data is the refinery acquisition cost in US dollars.

SOURCE Estimates by the Economic Council of Canada.

Table D-1

Selected Indicators for the Canadian Economy, Higher-Oil-Price Scenario, 1991-95

	1991	1992	1993	1994	1995
			(Per cent)		
Growth in:					
Real GDP					
Base case	1.3	4.0	3.4	3.2	3.1
Higher oil price	0.7	3.6	3.5	3.3	3.2
Consumer price index					
Base case	6.0	4.3	4.3	4.0	4.0
Higher oil price	6.3	4.3	4.2	3.9	3.9
Level of:					
Unemployment rate					
Base case	8.2	7.9	7.8	7.8	7.7
Higher oil price	8.3	8.1	8.1	8.0	7.9
90-Day Treasury Bill rate					
Base case	12.0	10.0	10.0	10.0	10.0
Higher oil price	12.5	10.3	10.1	10.0	9.9
As a proportion of GDP:					
Federal balance					
Base case	–3.7	–2.9	–2.2	–1.6	–1.0
Higher oil price	–3.9	–3.2	–2.4	–1.9	–1.2
Federal debt					
Base case	45.5	45.8	45.3	44.5	43.0
Higher oil price	45.7	46.3	46.1	45.4	44.1
Current-account balance					
Base case	–2.6	–2.1	–1.3	–1.0	–0.7
Higher oil price	–2.5	–2.0	–1.3	–1.0	–0.8

SOURCE Estimates by the Economic Council of Canada, July and August 1990.

Under these assumptions, short-term interest rates increase about 50 basis points, and the value of the Canadian dollar rises by up to 2 cents.

In summary, an oil-price shock puts more downward pressure on growth and more upward pressure on prices in the short run. In particular, it puts more stress on the manufacturing sector since energy input costs rise and the Canadian dollar appreciates. But the oil shock does not, by itself, push the economy into recession, unless it is accompanied by a broadly based deterioration in consumer confidence or unless the blip in inflation leads to a wage/price spiral that will, later on, bring about action by the central bank. If consumers react by curtailing their spending, for example, the slowdown will spread from manufacturing to the service sector, resulting in a generalized decline in economic activity. (In the Recession Risk case shown in Chapter 2, it is a jump in interest rates that causes this shakeout in confidence.)

E Unemployment and Economic Structure

The disaggregation of interprovincial unemployment-rate disparities into structural and nonstructural components is described in some detail in "Unemployment disparity: An analysis of the role of economic structure," a forthcoming Economic Council working paper written by Andrew Burns. The exercise is based on the observation that certain industries and certain groups of workers have higher unemployment rates than others and that different provinces have different concentrations of high- and low-unemployment industries and workers. For example, workers in the fishery, resource-extraction, and construction industries have, on average, higher unemployment rates than workers in the service sector. Similarly, women have higher average unemployment rates than men; youths have higher rates than prime-age males.

Aggregate unemployment rates can be higher in one province than in another either because the provincial labour force contains relatively more high-unemployment workers and industries (i.e., for structural causes) or because local labour markets tend tc generate higher unemployment rates, independently of the characteristics of firms or individual workers (i.e., for nonstructural causes). The distinction between structural and nonstructural causes of regional unemployment is made clearer with the aid of some simple mathematics. The unemployment rate in any province is identically equal to the sum across sectors of the product of sectoral unemployment rates and sectoral labour-force shares.

$$UR_j \equiv \sum_{i=0}^{I} UR_{ij} \times \frac{n_{ij}}{N_j} \qquad \text{E.1}$$

The unemployment rate in any province j can differ from the unemployment in another province either because sectoral unemployment rates (UR_i) differ from province to province, or because one province has relatively more workers in high-unemployment sectors than another (i.e., their labour force shares n_{ij}/N differ).

If sectoral unemployment rates are the same, then differences in provincial unemployment rates result solely from the relative concentration of workers with high-risk unemployment characteristics and/or workers working in relatively unemployment-prone sectors. Provincial aggregate unemployment rates differ because the weights given to high-unemployment-rate sectors/characteristics are different. If, however, sectoral unemployment rates differ across provinces, differences in provincial aggregate rates are also caused by nonstructural factors such as conditions in local labour markets, climate, historical and/or cultural institutions, or regionally distinct policy factors that cause labour markets in one province to operate differently than labour markets in other provinces.

In order to separate the influence of differences in the structure of provincial economies from nonstructural influences, we calculated a structurally corrected unemployment rate for each province. The structurally corrected unemployment rate (UR_j^c) is calculated from equation E.1, using the province's own sectoral unemployment rates UR_{ij} and a uniform set of weights n_k/N_k. In our analysis, we used Ontario's actual weights as the benchmark, and thus we ended up estimating the extent to which the difference between the Ontario unemployment rate and those of the other provinces is attributable to structural factors. Among the factors controlled for were: industrial structure; occupational mix; urban/rural location; size of city; full- vs. part-time work; and labour force characteristics, such as educational status, age/sex profile, linguistic and immigration profile, marital and household status, mobility, and minority status.

$$UR_j^c = \sum_{i=0}^{I} UR_{ij} \times \frac{n_{i,ont}}{N_{ont}} \qquad \text{E.2}$$

The corrected unemployment rates are equivalent[1] to observing unemployment rates for all individuals of a given age and sex, working in a given industry, at a given occupation, with a given educational, marital, immigration, linguistic, and urban/rural status for all possible combinations of these (and other) characteristics, and calculating what the aggregate unemployment rate would have been if these characteristic groups had the same labour-force shares in other provinces as they do in Ontario.

The structurally corrected unemployment rate tells us what the rate would be in each province if its industrial structure and the characteristics of its labour force were the same as Ontario's. The difference between the observed unemployment rate and the structurally corrected

unemployment rate measures the extent to which differences in economic structure explain differences in provincial unemployment rates. In Chart 3-3, the difference between the unemployment rate of Ontario and those of the other provinces is broken down into a structural and a nonstructural component. The structural component is equal to $UR_j - UR_j^c$ while the nonstructural component is equal to $UR_j^c - UR_{ont}$.

Notes

Chapter 1

1 Leonid Abalkin, Deputy Prime Minister of the U.S.S.R., cited in Ilya Gerol, "An analysis of the political-economic situation in the Soviet Union, 1985-1990," a background paper prepared for the Economic Council of Canada, Ottawa, July 1990.

2 For details, see Carl H. McMillan, "Integrating the Soviet and Eastern European economies into the world economy in the 1990s," a background paper prepared for the Economic Council of Canada, Ottawa, July 1990.

3 Organisation for Economic Co-operation and Development, *Agricultural Policies, Markets and Trade: Monitoring and Outlook, 1990* (Paris, 1990).

4 For an analysis that is similar to the one presented here, see John A. Sawyer, "Foreign trade and the changing industrial structure of Canada, 1961-1985," Working Paper no. 29, Ontario Centre for International Business, Toronto, April 1990.

5 To calculate the real rate of interest for a bond of a given maturity, the rate of inflation anticipated over the life of the bond is subtracted from the nominal rate. Various methods for estimating inflation expectations and real interest rates are found in the economic literature. Although the levels of estimated real rates vary somewhat from one study to another, at the short end of the maturity spectrum they all display an increase similar to that shown in Table 1-3 for the 1980s relative to the 1960s and 1970s.

Chapter 2

1 Economic Council of Canada, *Legacies*, 26th Annual Review (Ottawa: Supply and Services Canada, 1989).

2 For details, see, for example, "Real wages in Canada: An analysis of recent trends," *Bank of Canada Review* (November 1989), pp. 3-17.

3 For more details concerning the exchange-rate issue, see Robert A. Mundell, "The overvalued Canadian dollar," a paper prepared for the Canadian Monetary Policy Review Board, Montréal, 23 April 1990; Thomas J. Courchene, "Zero means almost nothing: Towards a preferable inflation and macro stance," a background paper prepared for the House of Commons Standing Committee on Finance, Ottawa, 7 June 1990; and Pierre Fortin, "Can the cost of anti-inflation policy be reduced in Canada?," a paper prepared for the C. D. Howe Institute workshop on "Zero inflation: The goal of price stability," Toronto, 5 March 1990.

4 Economic Council of Canada, *Back to Basics*, 25th Annual Review (Ottawa: Supply and Services Canada, 1988), pp. 24-25.

5 The inflation-control alternative maintains a real interest rate that is higher by 1 percentage point than that contained in the base case. Our assumption here is that the target of the Bank of Canada is, in fact, price stability (i.e., zero inflation); however, given our horizon, only 1 point in inflation can be squeezed from the system during and after the period when the GST is introduced. As indicated in the text, an operational target of 3 per cent is assumed by 1995. Finally, we assume that the bank, under these circumstances, continues the fight against inflation by maintaining some slack in the system as a signal of its intention to achieve its target of price stability.

Chapter 3

1 See Andrew Burns, "Unemployment disparity: An analysis of the role of economic structure," Working Paper, Economic Council of Canada (forthcoming).

2 Economic Council of Canada, *Handling the Risks: A Report on the Prairie Grain Economy* (Ottawa: Supply and Services Canada, 1988).

3 ECC, *Handling the Risks*, p. 71.

4 Leslie Harris, *Independent Review of the State of the Northern Cod Stock: Final Report*, Northern Cod Review Panel (Ottawa: Department of Fisheries and Oceans, February 1990).

5 Economic Council of Canada, *Managing Adjustment* (Ottawa: Supply and Services Canada, 1988).

6 See, in particular, Economic Council of Canada, *Making Technology Work: Innovation and Jobs in Canada* (Ottawa: Supply and Services Canada, 1987); and Economic Council of Canada, *Good Jobs, Bad Jobs: Employment in the Service Economy* (Ottawa: Supply and Services Canada, 1990).

7 See Miles Corak, "Canadian unemployment in retrospect, 1977-1987," Working Paper no. 10, Economic Council of Canada, Ottawa, 1990.

8 The OECD calculates standardized unemployment rates for 16 countries, using data from annual labour-force surveys to

adjust registered unemployment in line with an international standard for defining the unemployed – namely, those of working age who are out of work and have actively sought a job during the past four weeks. This number is then expressed as a percentage of the total labour force. For some countries, such as the United States, Japan, and Canada, virtually no adjustment is needed to official national rates, since their systems for calculating unemployment already conform with this standard.

But even comparisons with the standardized rates are not foolproof. Two countries may have identical standardized rates, yet have quite different underlying conditions in their labour markets. For example, Japan ignores the vast amount of disguised unemployment resulting from the system of lifetime employment in the big Japanese companies. These companies redeploy workers, extend holidays, cut overtime, or give early retirement rather than actually throw people out of work.

9 Göran Therborn, *Why Some People Are More Unemployed Than Others: The Strange Paradox of Growth and Unemployment* (London: Verso, 1986); Diane Bellemare and Lise Poulin-Simon, *Le défi du plein emploi : Un nouveau regard économique* (Montréal: Éditions Saint-Martin, 1986); Clarence L. Barber and John C. P. McCallum, *Controlling Inflation: Learning from Experience in Canada, Europe and Japan* (Ottawa: Canadian Institute for Economic Policy, 1982); Keith Banting, ed., *The State and Economic Interests*, Royal Commission on the Economic Union and Development Prospects for Canada, Study no. 32 (Ottawa: Supply and Services Canada, 1986); and Robert M. Campbell, "A review of the commitment to the full employment objective in Canada, 1945-1985," a background paper prepared for the Economic Council of Canada, Ottawa, July 1989.

10 Barber and McCallum, *Controlling Inflation*, p. 65.

11 For a fuller discussion of this topic, see Campbell, "Review."

12 Canada, Department of Reconstruction, *Employment and Income, with Special Reference to the Initial Period of Reconstruction* (Ottawa: Queen's Printer, 1945).

13 *Employment and Income*, p. 1,23.

Chapter 4

1 Organisation for Economic Co-operation and Development, *Labour Market Policies for the 1990s* (Paris, 1990).

2 Economic Council of Canada, *From the Bottom Up: The Community Economic-Development Approach* (Ottawa: Supply and Services Canada, 1990).

3 *Adjusting to Win*, Report of the Advisory Council on Adjustment (Ottawa: Supply and Services Canada, 1989); *Report of the CLMPC Task Forces on the Labour Force Development Strategy* (Ottawa: Canadian Labour Market and Productivity Centre, 1990).

4 Donald Macdonald, chairman, *Report of the Royal Commission on the Economic Union and Development Prospects for Canada* (Ottawa: Supply and Services Canada, 1985); Claude Forget, chairman, *Report of the Commission of Enquiry into Unemployment Insurance* (Ottawa: Employment and Immigration Canada, 1986).

5 *Building on Our Strengths*, Report of the Royal Commission on Employment and Unemployment in Newfoundland and Labrador (St. John's: Queen's Printer, 1986).

6 The Council pointed out that financing responsibilities for the EI fund would have to be negotiated. "In principle, government contributions should cover initiatives under the EI fund that are perceived to have 'social' benefits for all Canadians; these would involve the 'active' options of the fund and would include, for example, the direct costs of training and counselling expenses. On the other hand, employee/employer contributions should be applied principally towards the income maintenance component of the fund." ECC, *Good Jobs, Bad Jobs*, p. 22.

7 Employment and Immigration Canada, *Success in the Works: A Profile of Canada's Emerging Workforce* (Ottawa, 1989).

8 See Corak, "Canadian unemployment in retrospect."

9 Syed Sajjadur Rahman and Surendra Gera, "Long-term unemployment: The Canadian experience," Working Paper no. 12, Economic Council of Canada, Ottawa (forthcoming).

10 These conclusions are based on calculations of the conditional probability of finding a job after a given period of unemployment. The results indicate that the majority of unemployed individuals find a job within four months of the moment they became unemployed. Beyond that period, the probability of finding a job becomes very low and tends not to change. According to the Council's estimates, shortening the eligibility period from 24 to 16 weeks would increase the number of potential participants in the program by about 10 per cent. See Miles Corak, "Eligibility rules in the Canadian Job Strategy: Shifting the burden or targeting the assistance?," Working Paper no. 8, Economic Council of Canada, Ottawa (forthcoming).

11 *People and Skills in the New Global Economy*, Premier's Council Report (Toronto: Province of Ontario, 1990).

12 Gordon Betcherman, Keith Newton, and Joanne Godin, *Two Steps Forward: Human-Resource Management in a High-Tech World*, Economic Council of Canada (Ottawa: Supply and Services Canada, 1990).

13 Martin L. Weitzman, *The Share Economy: Conquering Stagflation* (Cambridge, Mass.: Harvard University Press, 1984).

14 For a discussion of the links between employment security and the seniority system, see Paul Osterman, *Employment Futures* (New York: Oxford University Press, 1988).

15 Macdonald, *Report*, vol. 2, p. 279.

16 See William D. Coleman, "Canadian business and the state," in Banting, ed., *The State and Economic Interests*.

17 Pradeep Kumar et al., "The current industrial relations scene in Canada, 1988," Industrial Relations Centre, Queen's University, Kingston, 1989.

18 See Barber and McCallum, *Controlling Inflation*; and Pierre Fortin, "Can Canadian anti-inflationary policy be made more cost-effective?," a paper read at the C. D. Howe Institute workshop on "Zero inflation: The goal of price stability," Université du Québec à Montréal, 1990.

19 See David A. Wilton, "An evaluation of wage and price controls," *Canadian Public Policy* (June 1985).

20 John Crow, "The work of Canadian monetary policy," Eric J. Hanson Memorial Lecture, University of Alberta, Edmonton, 18 January 1988.

21 The 6&5 program sought to limit wage and price increases to 6 per cent during its first year and to 5 per cent the following year. To set an example, the federal government made the application of this program mandatory in the federal public sector. The provincial governments and the private sector were urged to follow the federal example and to voluntarily limit price and wage increases to the levels set in the federal program. Most of the provinces fell into line, following discussions with the federal authorities. The private sector also responded favourably. The federal program involved limiting the prices administered by federal departments, agencies, and Crown corporations such as Air Canada, CN, Via Rail, Petro Canada and Canada Post. Also targeted were the prices set by federal regulatory bodies, including the Canadian Transport Commission, the Canadian Radio-Television and Telecommunications Commission, the National Energy Board, and the agricultural marketing boards.

22 For a detailed analysis, see Jean-Pierre Voyer, "Recent trends in wages: Is the slowdown purely cyclical?," Research Report no. 14, National Union of Provincial Government Employees, Ottawa, June 1985.

23 The recent budgetary measure whereby the growth of transfers under the Canada Assistance Plan is limited to 5 per cent during the next two years for the provinces that are in the best financial shape (i.e., Ontario, British Columbia, and Alberta) constitutes a moderate form of differentiated fiscal policy.

24 See Courchene, "Zero means almost nothing."

Appendix E

1 "Equivalent" because in the actual calculation of the corrected unemployment rates, we used individual unemployment probabilities based on individual and labour market characteristics. That is precisely analogous to the discussion in the text, as in effect the calculated subsector unemployment rates are estimates of the expected unemployment rate for group members. The only difference between our calculations is in the manner in which these probabilities were estimated.

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